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Constructive Trusts in Bankruptcy

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CONSTRUCTIVE TRUSTS IN BANKRUPTCY

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I. INTRODUCTION

A constructive trust is a restitutionary remedy developed in equity to give relief against unjust enrichment. It has been called "the formula by which the conscience of equity finds expression."[1] The purpose of this article is to consider whether and how the conscience of equity should express itself in a bankruptcy proceeding.

The constructive trust remedy applies to all forms of unjust enrichment, whenever the enrichment is represented in specific property. The substantive basis for the trust may be misappropriation, fraud, mistake, breach of fiduciary duty, or abuse of confidential relations. A constructive trust allows the injured party to claim restitution of specific property traceable to her claim, either in its original form or as the product of exchange.[2] The right to specific restitution has important consequences if the defendant is in bankruptcy, because it places the constructive trust claimant ahead of other creditors with respect to the property at issue.

Most bankruptcy courts have enforced constructive trust claims as a form of state law entitlement: if the state court would impose a constructive trust on certain property in an action between the claimant and the debtor, the bankruptcy court treats the claimant as the equitable owner of the property and allows her to recover it in bankruptcy, to the exclu-

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For simplicity, the author has chosen to refer to all plaintiffs or claimants as "she" and all defendants or debtors as "he," unless the facts of a case are otherwise.

1. Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 386, 122 N.E. 378, 380 (1919).

2. RESTATEMENT (SECOND) OF RESTITUTION § 30 (Tent. Draft No. 2, 1984); J. DAWSON, UNJUST ENRICHMENT 26-33 (1951); 1 G. PALMER, THE LAW OF RESTITUTION §§ 1.3, 1.4 (1978).

Some authorities have treated an order for specific restitution in connection with rescission of a contract or property transfer as a form of constructive trust, while others have distinguished the two. *See* 1 G. PALMER, *supra*, § 1.3, at 14; 2 *id.* § 11.5(b), (c). *Compare* RESTATEMENT OF RESTITUTION § 160 comment k (1937) *with* RESTATEMENT (SECOND) OF RESTITUTION § 8 comment e, at 97 & illustration 3 (Tent. Draft No. 1, 1984). In the tentative draft of the *Restatement (Second) of Restitution*, "specific restitution" refers to restoration of particular property transferred by the plaintiff to the defendant, while a "constructive trust" is the remedy courts grant when tracing is necessary to give complete relief. RESTATEMENT (SECOND) OF RESTITUTION §§ 30, 32 (Tent. Draft No. 2, 1984). For the purposes of this article, these two remedies raise similar issues, and the term "constructive trust" includes both.

sion of other creditors.[3] This result is consistent with the prevailing approach to property rights in bankruptcy, but it is not always intuitively satisfying. In some cases at least, there is no evident substantive reason why the constructive trust claimant should fare so much better than other creditors. Sensing something amiss, courts have imposed a number of technical restrictions on the operation of the constructive trust remedy in bankruptcy. These limiting rules are inadequate, however, because they do not address the underlying question of unjust enrichment as it applies to a contest between the constructive trust claimant and other creditors.

The following article begins descriptively, reviewing the theory and operation of the constructive trust remedy and its application in recent bankruptcy cases. It then moves to the more difficult question why a constructive trust claimant is given priority over other creditors: what justifies a remedy that allows one creditor—the constructive trust claimant—to bypass others and receive payment in full?[4] Excluding formal explanations, the only acceptable answer is that other creditors will be unjustly enriched if they are allowed to share in the assets at issue.

Part IV of the article traces three elements of a constructive trust claim that favor the constructive trust claimant in relation to other creditors. The case for priority depends on (1) the special appeal of a claim based on unjust enrichment, (2) identification of assets that represent the debtor's unjust enrichment in the bankruptcy estate, and (3) the claimant's position as an involuntary creditor. When all of these elements are present, a constructive trust may be appropriate to prevent unjust enrichment of general creditors at the claimant's expense.

Assuming the reasons identified in Part IV are sufficient to justify a constructive trust and elevate the claimant above other tort or contract creditors, several additional conclusions (and problems) follow. First, the three elements described in Part IV are not common to all constructive trust claims. When one or more are absent, a constructive trust might be appropriate in a state court action between the claimant and the debtor, but not in a bankruptcy contest between the claimant and other creditors. To apply the remedy properly, the bankruptcy court must reevaluate the question of unjust enrichment in the context of bankruptcy, with reference to its impact on other creditors involved in the proceeding. Part V explores different types of constructive trust claims to determine the proper limits of the constructive trust remedy in bankruptcy.

Second, application of the constructive trust remedy in bankruptcy cases requires further consideration of the respective roles of federal and

3. Bankruptcy cases that take this approach are cited and discussed *infra* notes 74-82 and accompanying text.

4. Many of the issues addressed here are raised in an interesting series of notes in D. LAYCOCK, MODERN AMERICAN REMEDIES: CASES AND MATERIALS 529-52 (1985).

state law in bankruptcy proceedings. Characterization of constructive trusts claims as state law entitlements that bankruptcy courts must accept without question leads to unsatisfactory results. State courts seldom consider the special problem of unjust enrichment among creditors in a collective proceeding. Practically, a federal bankruptcy court cannot bring the constructive trust remedy into line with the principle of unjust enrichment unless it assumes control of the decision and allocates priority as each case demands. As long as bankruptcy courts treat constructive trust claims as fixed entitlements based on state law precedent, the remedy will continue to miss its mark and produce disturbing decisions. Part VI briefly discusses these problems in connection with several current views on the relation between state and federal law in bankruptcy.

II. CONSTRUCTIVE TRUSTS

A. Unjust Enrichment

The substantive basis for imposing a constructive trust is unjust enrichment represented by property.[5] Constructive trusts were first used as a remedy for misappropriation or breach of duty by fiduciaries, but courts have since extended them to a much wider range of cases in which one party has been unjustly enriched at the expense of another.[6] Unjust enrichment is a broad concept: it refers to any case in which the defendant received a benefit that, for reasons of fairness, he should not retain.[7] Unjust enrichment can be a gain acquired tortiously, as by fraud or theft,[8] or a gain acquired by means that are simply unfair, such as abuse

5. RESTATEMENT (SECOND) OF RESTITUTION § 30 & comment b (Tent. Draft No. 2, 1984).

6. J. DAWSON, *supra* note 2, at 26-28; 1 G. PALMER, *supra* note 2, § 1.3, at 9-12, § 2.14, at 177-78. This statement describes American decisions; English courts have confined the constructive trust remedy to cases of fiduciary misconduct. 1 G. PALMER, *supra* note 2, § 1.3, at 11-12; Waters, *The English Constructive Trust: A Look Into The Future*, 19 VAND. L. REV. 1215, 1219-20 (1966).

Categories of cases in which courts have granted relief by constructive trust are set out in RESTATEMENT OF RESTITUTION §§ 163-171, 180-201 (1937); G. BOGERT & G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES §§ 473-501 (rev. 2d ed. 1978); and 5 A. SCOTT, THE LAW OF TRUSTS §§ 465-473, 482-506 (3d ed. 1967). Useful surveys of decisions are in Banks, *A Survey of the Constructive Trust in Tennessee*, 12 MEM. ST. U.L. REV. 71, 136-53 (1981); Jennings & Shapiro, *The Minnesota Law of Constructive Trusts and Analogous Equitable Remedies*, 25 MINN. L. REV. 667, 688-718 (1941); Lacy, *Constructive Trusts and Equitable Liens in Iowa*, 40 IOWA L. REV. 107, 119-34 (1954); and Lauerman, *Constructive Trusts and Restitutionary Liens in North Carolina*, 45 N.C.L. REV. 424, 428-44 (1967).

7. *See* J. DAWSON, *supra* note 2, at 1-26; 1 G. PALMER, *supra* note 2, § 1.1. Professor Dawson described Lord Mansfield's adoption of the principle of unjust enrichment in Moses v. Macferlan, 97 Eng. Rep. 676 (K.B. 1760), in this way: "Lord Mansfield adjusted his seat belt as firmly as possible and rocketed up into the stratosphere." J. DAWSON, *supra* note 2, at 12.

8. *See* RESTATEMENT OF RESTITUTION §§ 166-169 (1937); D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 5.15, at 419-21, § 9.4, at 627-29 (1973); 1 G. PALMER, *supra* note 2, § 2.2(b), § 3.4, at 237-38. If the defendant holds property stolen from the plaintiff, a constructive trust is not necessary. Neither the thief nor subsequent transferees have title to the stolen property, and restitution is available by other means. But if the converter has exchanged the original stolen property for something new, the constructive trust remedy comes into play and permits the plaintiff to claim the substituted property. RESTATEMENT OF RESTITUTION § 160 comment j (1937); 1 G. PALMER, *supra* note 2, § 2.2(b), § 3.4, at 237-38.

of a confidential relationship.[9] The principle of unjust enrichment also applies to cases of mistake, in which the defendant acquired a benefit innocently, but should not be permitted to keep the benefit at the plaintiff's expense.[10]

Most forms of unjust enrichment involve both a gain to the defendant and a loss to the plaintiff.[11] If the defendant embezzles money from the plaintiff, the defendant's gain is at the plaintiff's expense, and the plaintiff's claim for restitution is very strong. In some situations, however, courts have used constructive trusts to capture a defendant's unjust gain although the plaintiff did not suffer a corresponding economic loss.[12] For example, if a fiduciary engages in a conflict-of-interest transaction, any profits he earns from the transaction are subject to a constructive trust for the beneficiary of the fiduciary relation, whether or not the defendant's profits were at the economic expense of the beneficiary.[13] The justification for restitution in such a case is to discourage breaches of fiduciary duty by removing the possibility of profit. The plaintiff receives a windfall, but the windfall is justified for reasons of deterrence.[14]

B. Remedies

There are various remedies for unjust enrichment, both legal and equitable in origin. The principal legal remedy is a damage action developed under the heading of quasi contract. When a defendant has obtained a benefit under circumstances amounting to unjust enrichment, the court implies a contractual obligation on the part of the defendant to turn over the unjust gain to the plaintiff, and enforces the imaginary con-

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9. *E.g.*, Sharp v. Kosmalski, 40 N.Y.2d 119, 351 N.E.2d 721, 386 N.Y.S.2d 72 (1976) (breach of understandings inherent in a relationship between an unsophisticated widower and a designing younger woman).

10. *E.g.*, First Nat'l Bank v. Hurricane Elkhorn Coal Corp. II (*In re* Hurricane Elkhorn Coal Corp. II), 32 Bankr. 737, 739-40 (W.D. Ky. 1983), *aff'd*, 763 F.2d 188 (6th Cir. 1985); RESTATEMENT OF RESTITUTION §§ 163-165 (1937); 3 G. PALMER, *supra* note 2, § 14.3; *see* 2 *id.* § 11.5(c).

11. 1 G. PALMER, *supra* note 2, § 2.10, at 133; 5 A. SCOTT, *supra* note 6, § 462.2; Dawson, *Restitution or Damages?*, 20 OHIO ST. L.J. 175, 176-77 (1959).

12. RESTATEMENT (SECOND) OF RESTITUTION § 32(d) comments a, b (Tent. Draft No. 2, 1984); RESTATEMENT OF RESTITUTION § 160 comment d (1937); 1 G. PALMER, *supra* note 2, § 2.10; 5 A. SCOTT, *supra* note 6, § 462.2. The tentative draft of the *Restatement (Second)* explains that restitution is justified when the defendant's gain represents either a financial loss to the plaintiff or an infringement of the plaintiff's legal interests. RESTATEMENT (SECOND) OF RESTITUTION § 32 comment b (Tent. Draft No. 2, 1984).

13. RESTATEMENT OF RESTITUTION §§ 194-197, 199 (1937); 1 G. PALMER, *supra* note 2, § 2.11. Another example in which the defendant's gain may not be matched by a quantifiable loss to the plaintiff is misuse of confidential information or trade secrets. *E.g.*, Snepp v. United States, 444 U.S. 507 (1980) (proceeds of book written by former CIA agent in violation of secrecy agreements); RESTATEMENT OF RESTITUTION § 200 (1937); 1 G. PALMER, *supra* note 2, § 2.8; 5 A. SCOTT, *supra* note 6, §§ 505-505.1; *see also* York, *Extension of Restitutional Remedies in the Tort Field*, 4 UCLA L. REV. 499 (1957) (discussing restitution of profits obtained by invasion of intangible rights, such as privacy and personality).

14. RESTATEMENT OF RESTITUTION § 197 comment c (1937); 1 G. PALMER, *supra* note 2, § 2.11, at 141.

tract by an award of damages.[15] The measure of damages is based on the amount of the defendant's gains.[16]

The constructive trust remedy developed in equity, by analogy to express trust arrangements in which one person holds legal title to property for the benefit of another.[17] The same concept of separate legal and beneficial interests in property suggested a remedy for unjust enrichment: if, under principles of unjust enrichment, the defendant holds title to property that ought to belong to the plaintiff, the court will treat the defendant as a trustee, holding title for the plaintiff's benefit.[18] At that point, however, the analogy to an express trust ends. The result of a constructive trust is a judicial decree ordering the defendant to convey the property to the claimant. The remedy does not depend on a consensual arrangement between the parties, nor does it establish an ongoing fiduciary relationship, as in the case of an express trust. A constructive trust is merely a means by which the court can say that the defendant must relinquish to the plaintiff property that represents an unjust enrichment.[19]

Another equitable remedy that creates rights in property is an equitable lien. An equitable lien gives its holder the right to satisfy a monetary restitution claim from specific property of the defendant.[20] Like a constructive trust, an equitable lien is a remedial idea: it arises not because the parties agreed on a lien but because the court has determined that the defendant received a benefit he should not retain.[21]

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15. Moses v. Macferlan, 97 Eng. Rep. 676 (K.B. 1760); J. DAWSON, *supra* note 2, at 10-26; D. DOBBS, *supra* note 8, § 4.2, at 233-40; 1 G. PALMER, *supra* note 2, § 1.2.

16. This is not as simple as it sounds. Damages are based on the benefit the defendant obtained, but the meaning of benefit changes with context and is affected by the different purposes and policies of restitution in particular cases. *See, e.g.*, Olwell v. Nye & Nissen Co., 26 Wash. 2d 282, 173 P.2d 652 (1946) (benefit from conversion of egg-washing machine measured by supposed savings on hourly wages of egg washers). Much of Professor Palmer's treatise explores the varied meanings of benefit or enrichment. *See, e.g.*, 1 G. PALMER, *supra* note 2, §§ 2.12, 2.16, 2.20, 3.12, 4.2, 5.3; 2 *id.* §§ 6.3, 7.4, 8.9; 3 *id.* § 16.8. Professor Dawson said: "Not much reflection is required for one to discover that at every point in this complex equation there are judgments of fairness and social policy, even before one faces the critical question, when is enrichment 'unjust'?" Dawson, *supra* note 11, at 177.

17. For historical background, see J. DAWSON, *supra* note 2, at 26-28; 1 G. PALMER, *supra* note 2, § 1.3, at 9-12.

18. Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 386, 122 N.E. 378, 380 (1919); G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 6-7; D. DOBBS, *supra* note 8, § 4.3, at 241-42; 5 A. SCOTT, *supra* note 6, § 462, at 3413; Lacy, *supra* note 6, at 114.

19. J. DAWSON, *supra* note 2, at 28, 32-33; 1 G. PALMER, *supra* note 2, § 1.3, at 12-13, § 1.4; 5 A. SCOTT, *supra* note 6, § 462.1, at 3414-16; Banks, *supra* note 6, at 73; Lacy, *supra* note 6, at 114; Monaghan, *Constructive Trust and Equitable Lien: Status of the Conscious and the Innocent Wrongdoer in Equity*, 38 U. DET. L. REV. 10, 11-12 (1960); Pound, *The Progress of the Law, 1918-1919 Equity*, 33 HARV. L. REV. 420, 421-22 (1920).

20. RESTATEMENT OF RESTITUTION § 161 comment b (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 (Tent. Draft No. 2, 1984); J. DAWSON, *supra* note 2, at 34-35; D. DOBBS, *supra* note 8, § 4.3, at 248-50; 1 G. PALMER, *supra* note 2, § 1.5(a); 5 A. SCOTT, *supra* note 6, § 463; Banks, *supra* note 6, at 91; Lacy, *supra* note 6, at 116; Monaghan, *supra* note 19, at 13.

21. *See* RESTATEMENT OF RESTITUTION § 161 & comment a (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 & comment b (Tent. Draft No. 2, 1984); J. DAWSON, *supra* note 2, at 34-35; D. DOBBS, *supra* note 8, § 4.3, at 249; 1 G. PALMER, *supra* note 2, § 1.5(a), at 20; 5 A. SCOTT,

In some situations the plaintiff may prefer an equitable lien to a constructive trust because the equitable lien allows her both to assert a lien on the property subject to her claim and to recover a personal judgment for any deficiency.[22] In other cases, the court may limit the plaintiff to an equitable lien, because the principle of unjust enrichment does not require the defendant to yield the entire property to the plaintiff. A typical example is a case in which the defendant stole money from the plaintiff and used it to make an improvement to his house. Rather than imposing a constructive trust on the entire house (or a fractional portion of the house), most courts would allow the plaintiff an equitable lien on the house to secure the amount of money stolen.[23]

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supra note 6, § 463, at 3425; Monaghan, *supra* note 19, at 12. For most purposes, this article treats equitable liens as a specialized form of the constructive trust remedy. References to "constructive trusts" will include equitable liens, except when the differences between the two remedies are important and specifically noted.

In addition to the restitutionary equitable lien described in the text, courts have used the term "equitable lien" to describe a form of equitable relief granted when the parties agreed to create a security interest, but the lien is legally ineffective for technical reasons. The court may allow the intended secured party an equitable lien on the property, but the equitable lien in that case is based on the agreement between the parties, rather than the general principle of unjust enrichment. *See* D. DOBBS, *supra* note 8, § 4.3, at 249; Banks, *supra* note 6, at 92-95; Lacy, *supra* note 6, at 117-19; Lauerman, *supra* note 6, at 448-50; Monaghan, *supra* note 19, at 12. In this article, the term "equitable lien" refers to restitutionary liens granted to correct unjust enrichment, without regard to the intent of the parties.

Another equitable remedy that is based on unjust enrichment and may establish rights in specific property is subrogation. Subrogation allows a plaintiff who has discharged an obligation the defendant owed to a third party to exercise whatever rights the third party had against the defendant, including security interests or priority over other creditors. RESTATEMENT OF RESTITUTION § 162 & comments a, d (1937); RESTATEMENT (SECOND) OF RESTITUTION § 31 (Tent. Draft No. 2, 1984); J. DAWSON, *supra* note 2, at 36-37; D. DOBBS, *supra* note 8, § 4.3, at 250-52; 1 G. PALMER, *supra* note 2, § 31.5(b); 5 A. SCOTT, *supra* note 6, § 464.

22. When the defendant is a "conscious wrongdoer," the *Restatement of Restitution* allows the plaintiff to elect either a constructive trust or an equitable lien. RESTATEMENT OF RESTITUTION § 202 (1937). If the plaintiff chooses a constructive trust, she is entitled to a conveyance of the property subject to the trust, but the conveyance is treated as a full satisfaction of her claim. Therefore, if the value of the property is less than the full amount of the restitutionary claim, the plaintiff will prefer an equitable lien on the property, which allows her to obtain a personal judgment for the balance due. RESTATEMENT (SECOND) OF RESTITUTION § 30 comment h (Tent. Draft No. 2, 1984); 1 G. PALMER, *supra* note 2, § 1.5(a), at 20; 5 A. SCOTT, *supra* note 6, § 508; Monaghan, *supra* note 19, at 15.

23. *See* RESTATEMENT OF RESTITUTION § 206 (1937); D. DOBBS, *supra* note 8, § 4.3, at 249-50; Lauerman, *supra* note 6, at 451-53. Another case in which the *Restatement* limits the plaintiff to an equitable lien is when the plaintiff seeks to recover from an innocent converter who acquired the plaintiff's property and exchanged it for other property without notice of the plaintiff's rights. RESTATEMENT OF RESTITUTION § 203 (1937). Commentators also have suggested that an equitable lien is more appropriate than a constructive trust when a wrongdoer used the plaintiff's property to pay premiums on life insurance for the benefit of the wrongdoer's dependents, *e.g.*, 1 G. PALMER, *supra* note 2, § 2.15(b) (recommending "common sense"); Monaghan, *supra* note 19, at 16-18, or when the defendant is insolvent and the impact of the constructive trust will fall on his creditors, 1 G. PALMER, *supra* note 2, § 2.14(c), at 143-45; *cf.* RESTATEMENT (SECOND) OF RESTITUTION §§ 41, 43 (Tent. Draft No. 2, 1984) (placing surprisingly few limitations on the plaintiff's right to elect a constructive trust).

C. *Operation of the Constructive Trust Remedy*

1. *Incidents of the Remedy*

One of the special attributes of a constructive trust is the claimant's right to trace property into substituted forms.[24] From an early point, courts held that the rights and remedies of the beneficiary of an express trust survive changes in the identity of the trust property and attach to new property obtained in exchange for the assets initially placed in trust. This principle applied not only to exchanges authorized by the terms of the trust, but also to unauthorized exchanges and products of misappropriation from the trust.[25]

As courts extended the constructive trust remedy to other forms of unjust enrichment, the tracing principle continued to apply, and became the distinguishing feature of the remedy. When a defendant has been unjustly enriched by an acquisition of property, a constructive trust permits the plaintiff to obtain specific restitution of any identifiable products or proceeds of the original property in the defendant's hands.[26] For example, if the defendant stole the plaintiff's money and used it to buy land, the plaintiff can reach and claim the land by means of a constructive trust.[27] The tracing principle applies in the same manner to an equitable lien, except that the result is a lien on traceable products, rather than an order to convey them to the plaintiff.[28] In either case, the right

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24. Good general discussions of tracing appear in G. BOGERT & G. BOGERT, *supra* note 6, § 921; J. DAWSON, *supra* note 2, at 28-33 (calling the remedy a "shambling creature"); D. DOBBS, *supra* note 8, § 4.3, at 242-44; 1 G. PALMER, *supra* note 2, § 2.14; Ames, *Following Misappropriated Property into Its Product*, 19 HARV. L. REV. 511 (1906). The special problems of tracing into and out of commingled funds are addressed in G. BOGERT & G. BOGERT, *supra* note 6, §§ 926-929; D. DOBBS, *supra* note 8, § 5.15, at 420-21, 1 G. PALMER, *supra* note 2, §§ 2.16-2.17; 5 A. SCOTT, *supra* note 6, §§ 515-521. For an excellent criticism of traditional tracing doctrine as a means of redressing unjust enrichment, see Oesterle, *Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306*, 68 CORNELL L. REV. 172, 195-98 (1983).

25. G. BOGERT & G. BOGERT, *supra* note 6, § 866; J. DAWSON, *supra* note 2, at 26-27; 1 G. PALMER, *supra* note 2, § 2.14, at 177; Oesterle, *supra* note 24, at 186-88; Williston, *The Right to Follow Trust Property When Confused With Other Property*, 2 HARV. L. REV. 28, 28-29, 32 (1888) ("The substitute for the original thing follows the nature of the thing itself so long as it can be ascertained as such."). Professor Scott stated that the right of a trust beneficiary to trace is "an application of the broader principle that where one person wrongfully disposes of property of another and acquires in exchange other property, the other is entitled to reach the property so acquired." 2 A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS § 130, at 407 (4th ed. 1987). Chronologically, however, the tracing principle developed first in the context of express trusts, and later was extended to other cases of unjust enrichment. J. DAWSON, *supra* note 2, at 26-27.

26. G. BOGERT & G. BOGERT, *supra* note 6, § 921, at 364-65; J. DAWSON, *supra* note 2, at 28; 1 G. PALMER, *supra* note 2, § 2.14, at 177-78; *see, e.g.*, American Sugar Ref. Co. v. Fancher, 145 N.Y. 552, 558-59, 40 N.E. 206, 207-08 (1895); Newton v. Porter, 69 N.Y. 133, 138-40 (1877); Ames, *supra* note 24, at 513-14.

27. *E.g.*, Nebraska Nat'l Bank v. Johnson, 51 Neb. 546, 71 N.W. 294 (1897). Professor Oesterle calls this "exchange tracing," as distinguished from tracing income from misappropriated property or tracing money into a commingled fund. Oesterle, *supra* note 24, at 173-74. All these forms of tracing are possible through the constructive trust remedy.

28. RESTATEMENT OF RESTITUTION § 202 & comment d (1937); J. DAWSON, *supra* note 2, at 34; 1 G. PALMER, *supra* note 2, § 2.14, at 176-77; 5 A. SCOTT, *supra* note 6, §§ 464, 508; Ames, *supra* note 24, at 514.

to trace extends, in theory, through any number of changes in the form of the property, subject to the practical difficulties of proof.[29]

The ability to trace and claim products has significant advantages for the claimant. If the defendant has exchanged the property for something more valuable, the plaintiff can claim the new item.[30] This produces a windfall for the plaintiff, but it is justified on grounds of deterrence—if the court allowed the defendant to keep the profit, the defendant and others in the same position would have an incentive for wrongdoing.[31]

A constructive trust also allows the plaintiff to follow the property she claims into the hands of subsequent transferees.[32] If one party obtains property in circumstances that would support a constructive trust, and then transfers the property to a third party who is not a bona fide purchaser, traditional doctrine holds that the property remains subject to the plaintiff's claim. As a result, the plaintiff can proceed against the

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29. G. BOGERT & G. BOGERT, *supra* note 6, § 921, at 370-71; 1 G. PALMER, *supra* note 2, § 2.14(a).

30. RESTATEMENT OF RESTITUTION § 202 & comment c (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 comment a, at 5, comment h, at 14, comment k & illustration 6 (Tent. Draft No. 2, 1984); D. DOBBS, *supra* note 8, § 4.3, at 242, 244; 5 A. SCOTT, *supra* note 6, § 508, at 3573; Ames, *supra* note 24, at 511. The most dramatic example is a case in which a wrongdoer used misappropriated money to pay premiums on insurance. *See* RESTATEMENT OF RESTITUTION § 202 comment j & illustration 13 (1937); Ames, *supra* note 24, at 511. Several commentators have criticized the use of a constructive trust in insurance cases and suggested that the more appropriate remedy is an equitable lien. *See, e.g.*, 1 G. PALMER, *supra* note 2, § 2.15(b); Monaghan, *supra* note 19, at 16-18; *see also* RESTATEMENT (SECOND) OF RESTITUTION § 41 & comment b (Tent. Draft No. 2, 1984) (court may limit relief when a constructive trust would allow the claimant a disproportionate recovery and impose hardship on third parties).

The claimant's ability to trace and claim products that are more valuable than the property she lost is more limited when the defendant obtained the enrichment in good faith. *See* 1 G. PALMER, *supra* note 2, § 2.14(b). *But cf.* Dawson, *Restitution Without Enrichment*, 61 B.U.L. REV. 563, 617-20 (1981) (suggesting that the extent of the court's commitment to full protection of the right infringed is more important than the good or bad faith of the defendant). The *Restatement of Restitution* limits the right to elect a constructive trust to cases in which the defendant is a "conscious wrongdoer." RESTATEMENT OF RESTITUTION § 202 (1937). When the defendant is an innocent purchaser from a thief, the claimant is limited to an equitable lien. RESTATEMENT OF RESTITUTION § 203 (1937); *see* 5 A. SCOTT, *supra* note 6, § 508; Monaghan, *supra* note 19, at 23-24. When the claimant seeks restitution from an innocent donee, the donee can elect between specific restitution of exchange products (as full satisfaction) or an equitable lien. RESTATEMENT OF RESTITUTION § 204 (1937); *see* 5 A. SCOTT, *supra* note 6, § 509, at 3595. An innocent donee also may have a defense based on change of position. *See* 5 A. SCOTT, *supra* note 6, § 509, at 3595; Monaghan, *supra* note 19, at 24-30. The tentative draft of the *Restatement (Second)* appears to retreat from this set of rules in favor of more general, discretionary limits on the claimant's rights against subsequent transferees. *See* RESTATEMENT (SECOND) OF RESTITUTION §§ 41(a), 43(2) (Tent. Draft No. 2, 1984).

Even in the case of a conscious wrongdoer, there are problems of apportionment when the value of products of an exchange of the original property is due, in part, to the skill or contribution of the defendant. *See* D. DOBBS, *supra* note 8, § 4.3, at 242-43; Oesterle, *supra* note 24, at 195-202.

31. RESTATEMENT OF RESTITUTION § 202 comment a (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 comment k (Tent. Draft No. 2, 1984); 5 A. SCOTT, *supra* note 6, § 508, at 3573; Ames, *supra* note 24, at 512; *see also* D. DOBBS, *supra* note 8, § 4.3, at 244 (suggesting that specific restitution of products also relieves the plaintiff of the burden of proving the value of the initial loss).

32. Commentators sometimes refer to this incident of the constructive trust remedy as a branch of the tracing principle. *See, e.g.*, G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 5-6, § 868, at 84. *But see* Oesterle, *supra* note 24, at 173 & n.2 (distinguishing the constructive trust claimant's rights against third parties from the right to trace).

third party and assert a constructive trust against the original property; or, at her option, she can proceed against the first recipient and claim the products of the exchange.[33] The plaintiff's ability to follow the property ends when it reaches a bona fide purchaser.[34] As in the case of other tracing rules, the right to follow property to third parties began as a rule about express trusts and was incorporated into the remedial counterpart.[35]

Another special feature of the constructive trust remedy is that the right to specific restitution gives the claimant priority over the defendant's unsecured creditors, to the extent of property subject to her claim.[36] In collective proceedings for collection of debts, a quasi contract claim for damages yields only a pro rata share of the debtor's available assets, while a constructive trust entitles the claimant to the whole of the property it affects.[37] Further, because the plaintiff can follow the property through changes in form, her priority extends not only to the initial enrichment, but also to traceable products of exchange.[38] An equitable lien provides similar advantages, although it does not permit the plaintiff to

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33. RESTATEMENT OF RESTITUTION § 160 comment d, § 161 comment d, § 168 (1937); RESTATEMENT (SECOND) OF RESTITUTION § 43 & comment a (Tent. Draft No. 2, 1984); G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 5-6; D. DOBBS, *supra* note 8, § 4.3, at 247; 1 G. PALMER, *supra* note 2, § 2.14, at 176; 5 A. SCOTT, *supra* note 6, § 510 (gratuitous transferees); Ames, *supra* note 24, at 514-18; Scott, *Restitution From an Innocent Transferee Who Is Not a Purchaser for Value*, 62 HARV. L. REV. 1002, 1002-03 (1949).

34. RESTATEMENT OF RESTITUTION §§ 168, 172 (1937); RESTATEMENT (SECOND) OF RESTITUTION § 43 comment a (Tent. Draft No. 2, 1984); D. DOBBS, *supra* note 8, § 4.3, at 247, § 4.7, at 283; 1 G. PALMER, *supra* note 2, § 2.14, at 176; 3 *id.* § 16.5, at 486; 5 A. SCOTT, *supra* note 6, § 474; Ames, *supra* note 24, at 517-18; Monaghan, *supra* note 19, at 21; Scott, *supra* note 33, at 1007-08. The rule protecting bona fide purchasers reflects both the equities between parties, *see* 5 A. SCOTT, *supra* note 6, § 474 (purchaser is not unjustly enriched), and broader concerns about the reliability of commercial transactions, *see* D. DOBBS, *supra* note 8, § 4.7, at 284-85; 3 G. PALMER, *supra* note 2, § 16.5, at 484; Monaghan, *supra* note 19, at 26-27; Scott, *supra* note 33, at 1008. *See generally* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954).

Bona fide purchasers are not protected in cases of conversion. Traditional rules hold that a thief acquires no title or interest that he can pass on to a subsequent purchaser; therefore, the original owner is entitled to restitution from the purchaser, even if he paid full value in good faith. RESTATEMENT OF RESTITUTION § 160 comment j (1937); D. DOBBS, *supra* note 8, § 4.7, at 281-82; 3 G. PALMER, *supra* note 2, § 16.5(a), at 480; Gilmore, *supra*, at 1059-60; Scott, *supra* note 33, at 1002. However, the court probably will limit the claimant's remedy to an equitable lien. *E.g.*, RESTATEMENT OF RESTITUTION § 203 (1937); *see supra* note 30. For discussion of the comparative positions of a bona fide purchaser who obtains title, a purchaser from a converter, and a donee who obtains title without notice of restitutionary rights, see Ames, *supra* note 24, at 514-18; Monaghan, *supra* note 19, at 22-32; Scott, *supra* note 33, at 1002, 1006-19. *See also* Oesterle, *supra* note 24, at 215-18.

35. J. DAWSON, *supra* note 2, at 27; *see* G. BOGERT & G. BOGERT, *supra* note 6, § 866, at 68, § 868, at 85-86; 4 A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS §§ 288-289 (4th ed. 1989).

36. *See* J. DAWSON, *supra* note 2, at 31; D. DOBBS, *supra* note 8, § 4.3, at 244; 1 G. PALMER, *supra* note 2, § 2.14, at 182; 5 A. SCOTT, *supra* note 6, § 508, at 3573, § 521, at 3649-52.

37. *See, e.g.*, American Hull Ins. Syndicate v. United States Lines, Inc. (*In re* United States Lines, Inc.), 79 Bankr. 542, 544-47, 551 (Bankr. S.D.N.Y. 1987) (constructive trust claimant was entitled to priority in traceable funds but was a general unsecured creditor with respect to the balance of its claim); 4 COLLIER ON BANKRUPTCY ¶ 541.13, at 541-75 to 541-76 (L. King 15th ed. 1989).

38. RESTATEMENT OF RESTITUTION § 202 & comments e, j (1937); 5 A. SCOTT, *supra* note 6, § 508, at 3573, § 521, at 3650; *see* 5 *id.* § 521, at 3649-52 (criticizing decisions that grant priority by

claim profits from appreciation or exchange of the property involved.[39]

The *Restatement of Restitution* treats the priority associated with a constructive trust as an inevitable incident of the claimant's restitutionary rights against the defendant. In the *Restatement*'s view, the plaintiff, as beneficiary of a constructive trust, is the equitable owner of the subject property. Creditors are not bona fide purchasers and should not be permitted to "profit because of the wrongful acquisition of property by their debtor."[40] Therefore, the claimant can recover the property (or in the case of an equitable lien, satisfy her claim from the property), to the exclusion of general unsecured creditors.[41]

This article rejects the *Restatement*'s position on creditors' rights. According to the analysis proposed here, priority over general creditors should not follow automatically from the plaintiff's right to a constructive trust against the defendant's property. Instead, the priority of a restitution claimant in bankruptcy (or a similar collective creditor proceeding) should be based on the strength of her claim in relation to the claims of competing parties who will bear the burden of the remedy. Put another way, the right to a contructive trust in bankruptcy should depend on whether *creditors* would be unjustly enriched by sharing in the property the plaintiff claims.[42]

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constructive trust when the plaintiff cannot trace to specific assets, but maintaining that creditors have no claim to traceable products of unjust enrichment).

39. *See, e.g.*, RESTATEMENT OF RESTITUTION § 161 comments b, c (1937).

40. RESTATEMENT OF RESTITUTION § 202 comment e (1937).

41. *Id.*; *see* 5 A. SCOTT, *supra* note 6, § 508, at 3573; Ames, *supra* note 24, at 521. The *Restatement* is correct in stating that unsecured creditors are not equivalent to bona fide purchasers of property: an unsecured creditor does not rely on the defendant's title to the property to the same extent as does a purchaser. *See infra* note 111 and accompanying text. But it does not follow that creditors should be disregarded in the decision to grant a constructive trust. The priority of a bona fide purchaser over a constructive trust claimant is not a magical formula. The bona fide purchaser prevails because it would be unfair, and perhaps inefficient, to require the purchaser to turn over the property to the claimant and seek recourse against the wrongdoer. In effect, the constructive trust claim is cut off because the bona fide purchaser has not been unjustly enriched. An unsecured creditor differs substantially from a purchaser, but the difference between them does not foreclose the question of unjust enrichment when the parties affected by a constructive trust are creditors. It means only that the balance of interests is different in a contest between the constructive trust claimant and creditors than in a contest between the claimant and a subsequent purchaser.

42. Not all writers agree with the *Restatement*'s view that claims of other creditors are irrelevant to the application of the constructive trust remedy. Professor Dawson indicated his view on the preference given to constructive trust claimants by remarking that "[i]t is quite extraordinary to observe the enthusiasm with which this purpose has been pursued by American courts." J. DAWSON, *supra* note 2, at 31. Professor Dobbs suggests that, at least when questionable presumptions aid tracing, it is unfair to allow the plaintiff a priority claim to assets much greater in value than the property originally taken from her. D. DOBBS, *supra* note 8, § 4.3, at 244-45.

Professor Palmer states that when the defendant is insolvent, courts should limit the plaintiff to an equitable lien, and that most courts have done so. 1 G. PALMER, *supra* note 2, § 2.14(c), at 182-85. Professor Palmer also questions the reasoning of the *Restatement*. He suggests that the source of the constructive trust claimant's priority over general creditors is not a property interest in the assets, but the nature of her restitution claim: creditors have assumed the risk of the defendant's insolvency, while the plaintiff has not. *See id.* § 2.14(c), at 185-86. This article takes a narrower view of the reasons for priority, *see infra* notes 130-78 and accompanying text, but Professor

2. *Tracing as a Requirement for Relief*

Constructive trusts and equitable liens are remedies against property. To obtain relief, the plaintiff must establish a connection between her right to restitution and the particular property she claims.[43] This is part of the tradition imported from trust law: a trust must have a trust res.[44]

Initially, the plaintiff must show that the defendant was unjustly enriched by acquisition or retention of certain property.[45] In some cases, the connection between the claim of unjust enrichment and a definable asset is clear, as when the defendant obtained a conveyance of property from the plaintiff by fraud or mistake or caused a donor to give him a gift intended for the plaintiff.[46] On the other hand, if the defendant induced

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Palmer's discussion is helpful, because it refers to the substance of the constructive trust claim rather than allowing the remedy to dictate its own consequences.

Both Professors Dobbs and Palmer seem to accept the premise that the plaintiff is entitled to priority in traceable assets to the extent of an equitable lien in the amount of the initial claim. Professor Oesterle, on the other hand, has questioned whether a constructive trust claimant should have any priority over other creditors. Oesterle, *supra* note 24, at 208-11.

The tentative draft of the *Restatement (Second)* makes faint concessions to the interests of creditors but does not abandon the premise that a claimant entitled to a constructive trust against the defendant normally can claim specific restitution at the expense of general creditors. *See* RESTATEMENT (SECOND) OF RESTITUTION § 43 & comments b, c (Tent. Draft No. 2, 1984).

43. RESTATEMENT OF RESTITUTION § 160 comment i (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 comments c, g, § 32 comment a (Tent. Draft No. 2, 1984); D. DOBBS, *supra* note 8, § 4.3, at 242; *see* Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 386, 122 N.E. 378, 380 (1919) (constructive trust applies whenever "property has been acquired in such circumstances that the holder of legal title may not in good conscience retain the beneficial interest"); G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 3 (constructive trust applies when one party "unfairly holds a property interest"); 5 A. SCOTT, *supra* note 6, § 462, at 3413 (constructive trust applies when one person holds property subject to a duty to convey to another); Ames, *supra* note 24, at 514 (referring to a "misappropriated res").

44. A comment in the *Restatement*, for example, states that there must be a "trust property" and cites the *Restatement of Trusts*. RESTATEMENT OF RESTITUTION § 160 comment i (1937). The reference to trust property reflects the view taken throughout the *Restatement* that a constructive trust has a substantive legal existence apart from the remedy the court ultimately grants between the parties.

45. The tentative draft of the *Restatement (Second)* attempts to enumerate the ways in which a restitution claimant can link her claim to property. RESTATEMENT (SECOND) OF RESTITUTION § 32 (Tent. Draft No. 2, 1984). Roughly, it lists cases in which: (1) the defendant holds property acquired from the plaintiff through a wrong or a mistake, *id.* § 32(a); (2) the defendant holds property the plaintiff would have received but for a wrong or mistake, *id.* § 32(b); or (3) the defendant holds property obtained by means of an infringement of the plaintiff's interests (such as unfair trade or breach of fiduciary duty), *id.* § 32(d). Additional provisions cover products of the original property and commingled masses containing property subject to the plaintiff's claim. *Id.* § 32(c)-(e). The drafter's comments explain that the necessary connection between the constructive trust claim and specific property exists when property in the defendant's hands represents either a loss to the plaintiff or an infringement of the plaintiff's rights. *Id.* § 32 comment c. The list is said to be exhaustive, though its lack of clarity may prevent its having that effect.

46. RESTATEMENT (SECOND) OF RESTITUTION § 32(a)-(b) (Tent. Draft No. 2, 1984); *see* RESTATEMENT OF RESTITUTION §§ 163, 165-167, 169, 184-185, 187-188 (1937). A case on the borderline is Simonds v. Simonds, 45 N.Y.2d 233, 380 N.E.2d 189, 408 N.Y.S.2d 359 (1978). A former spouse claimed proceeds of a life insurance policy, based on a settlement agreement in which the insured had promised to maintain policies payable to the plaintiff. The insured had allowed the original policies to lapse and obtained new policies payable to a second spouse. The court imposed a constructive trust (really an equitable lien) on the proceeds of the new insurance policies in favor of

the plaintiff by fraud to perform a valuable service, there is no property that can serve as the basis of a constructive trust. In that case, the plaintiff is limited to a monetary claim for the value of the service, and her claim stands on an equal footing with the claims of unsecured creditors.[47]

Standard tracing doctine also holds that the plaintiff must identify the specific assets that represent her claim at the time of trial. If the defendant no longer holds the initial property, the plaintiff can claim its products, but she must trace the property though the series of transactions leading from its original to its present form.[48] Professor Scott was a leading defender of this requirement, arguing that the priority resulting from a constructive trust is justified only if the plaintiff can point to the property obtained at her expense or its product by exchange.[49]

Some writers have proposed an alternative view that would allow the plaintiff to claim a constructive trust (or more precisely, an equitable lien) on general assets of the defendant, if the plaintiff could establish that the defendant's assets were "swelled" by the unjust enrichment. In other words, if property subject to the plaintiff's restitution claim entered and augmented the defendant's pool of assets, the plaintiff would be entitled to an equitable lien for the amount of the enrichment, without tracing specific products held by the defendant at the time of trial.[50] Most

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the plaintiff. To find a sufficient connection between the plaintiff's claim and the insurance proceeds, the court relied on the concept of equitable assignment and the maxim that "equity regards as done that which should have been done." *Id.* at 239-41, 380 N.E.2d at 192-93, 408 N.Y.S.2d at 362-63; *see* Gegan, *Constructive Trusts: A New Basis for Tracing Equities*, 53 ST. JOHN'S L. REV. 593 (1979) (criticizing *Simonds*). The tentative draft of the *Restatement (Second)* treats this type of case as an exception to the tracing requirement. RESTATEMENT (SECOND) OF RESTITUTION § 33(2) & comment a (Tent. Draft No. 2, 1984).

47. RESTATEMENT OF RESTITUTION § 160 comment i (1937). Another example is a claim for the value of the defendant's use of misappropriated property. *E.g.*, Olwell v. Nye & Nissen Co., 26 Wash. 2d 282, 173 P.2d 652 (1946) (misappropriation of an egg-washing machine).

48. RESTATEMENT OF RESTITUTION § 160 comment i, § 202 comment i (1937); RESTATEMENT (SECOND) OF RESTITUTION § 32(c) comment c, at 50-51, comment e, at 57-58 (Tent. Draft No. 2, 1984); G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 4-5, § 921, at 362-70; D. DOBBS, *supra* note 8, at § 4.3, 242, § 5.16, at 426; 1 G. PALMER, *supra* note 2, § 2.14, at 182-83; 5 A. SCOTT, *supra* note 6, § 521, at 3649-50. Professor Oesterle describes the prevailing tracing rules as "transactional," rather than "causal." In other words, the plaintiff's right to a constructive trust or equitable lien depends not on proof of a net increase in the defendant's assets but on proof of a connection to the original property by exchange, income, or commingling. Oesterle, *supra* note 24, at 173-75. Professor Oesterle criticizes traditional tracing doctrine, saying it is not an accurate measure of unjust enrichment and produces results that are arbitrary and unrelated to substantive restitutionary goals. *Id.* at 185-86, 195-211.

49. 5 A. SCOTT, *supra* note 6, § 521, at 3649-52. Professor Scott recognized some exceptions to the tracing requirement (notably in cases of commingled funds), but in general, he insisted on identification of the res in its original or substituted form. *See id.* §§ 515-519.

50. The swelled asset theory is described in G. BOGERT & G. BOGERT, *supra* note 6, § 921, at 372-74, § 922; D. DOBBS, *supra* note 8, § 5.16, at 426-27; 1 G. PALMER, *supra* note 2, § 2.14(c), at 182-83; 5 A. SCOTT, *supra* note 6, § 521, at 3648-49; Ames, *supra* note 24, at 521-22; Taft, *A Defense of a Limited Use of the Swollen Assets Theory Where Money Has Wrongfully Been Mingled with Other Money*, 39 COLUM. L. REV. 172, 173-74 & n.7 (1939); Williston, *supra* note 25, at 36-39. Professor Scott identified two versions of the theory. One he called "original augmentation." This version would allow the plaintiff priority upon proof that property subject to the plaintiff's restitution claim had entered into the defendant's assets at one time. The second, which Scott called "ultimate augmentation," would require the plaintiff to show that the defendant had not dissipated the

courts, however, have adopted the view of Professor Scott.[51]

One of the more complex aspects of tracing doctrine is following money or other fungible property into a commingled mass.[52] Summarizing briefly, most courts have adopted rules or presumptions that permit a constructive trust claimant to recover a portion of the commingled fund, although the original money or property has lost its identity. The right to trace into the fund is based on the assumption that some part of the fund must be the claimant's, and the defendant's commingling of assets should not be enough to cut off her claim.[53] Problems arise, however, if the defendant later withdrew portions of the fund. Some courts have

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value of the original contribution prior to trial. For example, the plaintiff could prevail by showing that the defendant used money stolen from the plaintiff to pay debts he otherwise would have paid from general assets. 5 A. SCOTT, *supra* note 6, § 521, at 3648-49.

Arguments in favor of the swelled asset theory appear in Ames, *supra* note 24, and Taft, *supra*. Professor Oesterle indicates his support for a controlled use of swelled asset concepts. Oesterle, *supra* note 24, at 203-10; *see also* 1 G. PALMER, *supra* note 2, § 2.14(c), at 186 (suggesting that transactional tracing can be arbitrary).

51. G. BOGERT & G. BOGERT, *supra* note 6, § 921, at 367-69; 1 G. PALMER, *supra* note 2, § 214(c), at 182-83. For illustrations of the tracing requirement in bankruptcy, see Cunningham v. Brown, 265 U.S. 1, 11 (1924) (strict tracing requirement); Turley v. Mahan & Rowsey, Inc. (*In re* Mahan & Rowsey, Inc.), 817 F.2d 682, 684 (10th Cir. 1987) (tracing required but plaintiff could trace into commingled funds); Toys "R" Us, Inc. v. Esgro, Inc. (*In re* Esgro, Inc.), 645 F.2d 794, 797-98 (9th Cir. 1981) (strict tracing requirement); Rosenberg v. Collins, 624 F.2d 659, 663 (5th Cir. 1980) (tracing required); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965-67 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980) (tracing required); Reliance Ins. Co. v. Brown, 40 Bankr. 214, 218 (W.D. Mo. 1984) (tracing required); Research Planning, Inc. v. Segal (*In re* First Capital Mortgage Loan Corp.), 60 Bankr. 915, 917, 920 (Bankr. D. Utah 1986) (tracing required); Varon v. Salomon (*In re* Martin Fein & Co.), 43 Bankr. 623, 627 (Bankr. S.D.N.Y. 1984) (tracing required, but plaintiff could trace into commingled funds); Schifter v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508, 514-15 (Bankr. S.D. Fla. 1983) (tracing required); U.S. Life Title Ins. Co. v. Steinberg (*In re* Independence Land Title Corp.), 18 Bankr. 673, 674 (Bankr. N.D. Ill. 1982) (tracing required). *But cf.* Heyman v. Kemp (*In re* Teltronics, Ltd.), 649 F.2d 1236, 1240-41 (7th Cir. 1981) (apparently imposing a constructive trust on general assets because state statute provided for ratable distribution among defrauded investors); First Nat'l Bank v. Hurricane Elkhorn Coal Corp. II (*In re* Hurricane Elkhorn Coal Corp. II), 32 Bankr. 737, 741 (W.D. Ky. 1983), *aff'd*, 763 F.2d 188 (6th Cir. 1985) (imposing a constructive trust on general assets of a bank that collected funds from an account in which the debtor had deposited money mistakenly paid by the claimant to the debtor).

State court decisions are collected in Banks, *supra* note 6, at 115-26; Jennings & Shapiro, *supra* note 6, at 720-29 (noting that Minnesota courts have sometimes applied a swelled asset theory); Lacy, *supra* note 6, at 134-35; Note, *The Necessity for Unjust Enrichment in a Constructive Trust in California:* Elliott v. Elliott, 19 HASTINGS L.J. 1268 (1968) (discussing a case in which the court imposed a constructive trust on general assets, apparently without proof that the defendant had been enriched, which the author viewed as an aberration in California law).

52. Tracing into and out of commingled funds is discussed in detail in RESTATEMENT OF RESTITUTION §§ 209-214 (1937); RESTATEMENT (SECOND) OF RESTITUTION §§ 35-41 (Tent. Draft No. 2, 1984); G. BOGERT & G. BOGERT, *supra* note 6, §§ 926-929; D. DOBBS, *supra* note 8, at § 5.16, 424-30; D. LAYCOCK, *supra* note 4, at 542-52; 1 G. PALMER, *supra* note 2, §§ 2.16-2.18; 5 A. SCOTT, *supra* note 6, §§ 515-520; Ames, *supra* note 24, at 518-20; Scott, *The Right to Follow Money Wrongfully Mingled with Other Money*, 27 HARV. L. REV. 125 (1913); Williston, *supra* note 25. For discussions of the right of a secured creditor to trace proceeds of collateral into a commingled fund under article 9 of the Uniform Commercial Code, see Weinberg, *The Malformed Mouse Meets the LIBR: Secured and Restitutionary Claims to Commingled Funds*, 8 ANN. REV. BANKING L. 269 (1989); Skilton, *The Secured Party's Rights in a Debtor's Bank Account Under Section 9-306(4)(d) of the Uniform Commercial Code*, 1978 S. ILL. U.L.J. 60 (1978).

53. *See, e.g.*, 5 A. SCOTT, *supra* note 6, § 515, at 3610-11.

relied on an obviously fictitious presumption that the defendant must have intended to withdraw his own money first, leaving the balance of the fund subject to the constructive trust claim.[54] The *Restatement of Restitution* rejects the fiction of intent and proposes instead that the claimant is entitled to an equitable lien on the balance of the fund in the amount of her original contribution to it.[55] Under both views the result is the same: the claimant can recover from the commingled fund, up to the amount of the lowest balance of the fund between the time the defendant deposited money subject to the constructive trust claim into the fund and the time of trial.[56] This approach may not reflect the actual, or even probable, whereabouts of the claimant's money,[57] but it is thought to be fair because it resolves uncertainies against the defendant who caused the ambiguity.[58]

3. *The Remedial Character of a Constructive Trust*

Nearly all literature on constructive trusts makes the point that a constructive trust is a remedy, rather than a substantive property right.[59] It is not a trust, but an analogy to a trust employed to correct unjust enrichment. Nevertheless, the right to a constructive trust is often

54. This tracing fiction originated with Knatchbull v. Hallett (*In re* Hallett's Estate), 13 Ch. D. 696 (C.A. 1880) and is discussed in G. BOGERT & G. BOGERT, *supra* note 6, § 926, at 410; D. DOBBS, *supra* note 8, § 5.16, at 427-29; 1 G. PALMER, *supra* note 2, § 2.16(a); and 5 A. SCOTT, *supra* note 6, § 517. The presumption that the defendant withdrew and spent his own funds first is designed to operate in favor of the constructive trust claimant when the defendant dissipated the withdrawal and there is a balance remaining in the commingled account. If the defendant invested the withdrawal in a traceable product and dissipated the balance of the account, courts normally reverse the presumption and allow the claimant at least an equitable lien on the product of the withdrawal. RESTATEMENT OF RESTITUTION §§ 210-211 (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 928; D. DOBBS, *supra* note 8, § 5.16, at 428-29; 1 G. PALMER, *supra* note 2, § 2.16(b); 5 A. SCOTT, *supra* note 6, § 517.1. The claimant may also be able to assert a constructive trust on the product of the withdrawal or some portion of it, resulting in problems that are far beyond the scope of this article. The issues are debated in RESTATEMENT OF RESTITUTION § 210(2) comments d, c, § 211(2) comment d (1937); D. DOBBS, *supra* note 8, § 5.16, at 429-30; D. LAYCOCK, *supra* note 4, at 543-45; 1 G. PALMER, *supra* note 2, § 2.17; and 5 A. SCOTT, *supra* note 6, § 517.2. Yet another complication occurs when the defendant first withdrew and dissipated funds in the account and then deposited new funds of his own. Usually, but not universally, the claimant has no right to the subsequent additions. RESTATEMENT OF RESTITUTION § 212 (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 929, at 431-32; D. DOBBS, *supra* note 8, § 5.16, at 425-26; 1 G. PALMER, *supra* note 2, § 2.16(a), at 199-200; 5 A. SCOTT, *supra* note 6, § 518.

55. RESTATEMENT OF RESTITUTION § 211(1) & comment a (1937); *see* 5 A. SCOTT, *supra* note 6, § 517, at 3623-24, § 517.1, at 3628; *see also* 1 G. PALMER, *supra* note 2, § 2.16(a), at 196 (equitable lien is a fiction as well).

56. D. DOBBS, *supra* note 8, § 5.16, at 425; 1 G. PALMER, *supra* note 2, § 2.16(a), at 199-201; 5 A. SCOTT, *supra* note 6, § 518, at 3634-35.

57. *See* Finkelstein & Robbins, *A Probabilistic Approach to Tracing Presumptions in the Law of Restitution*, 24 JURIMETRICS J. 65 (1983).

58. *See* 1 G. PALMER, *supra* note 2, § 2.16(a), at 196; 5 A. SCOTT, *supra* note 6, § 515, at 3610-12.

59. *E.g.*, RESTATEMENT OF RESTITUTION § 160 comment a (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 7; J. DAWSON, *supra* note 2, at 32; D. DOBBS, *supra* note 8, § 4.3, at 241; 1 G. PALMER, *supra* note 2, § 1.4, § 2.14, at 184, § 2.15, at 190-91; 5 A. SCOTT, *supra* note 6, § 462, at 3413, § 462.1, at 3414-16; Banks, *supra* note 6, at 73; Lacy, *supra* note 6, at 107, 110-14; Monaghan, *supra* note 19, at 11-12; Pound, *supra* note 19, at 420-23.

equated with ownership of the property to which the remedy applies.[60] The notion of equitable ownership results from the trust analogy. The beneficiary of an express trust does not have legal title to trust property, but she has rights against the trustee and others that are enforceable by equitable remedies and therefore take on the character of property.[61] In applying the constructive trust remedy, courts often assume a plaintiff asserting a restitution claim against property must be accorded a parallel status and treated as the equitable owner of the property she claims.[62]

Equating constructive trust claims with equitable ownership is misleading. Unlike the beneficiary of an express trust, a constructive trust claimant has no independent interest in the property at issue. Equitable ownership merely states the consequences of the remedy, if granted; it is not a reason to grant relief to the claimant. When the concept of equitable ownership is confused with the reasons for granting the remedy, it obscures the function of the constructive trust as a means of preventing unjust enrichment.[63]

The distorting influence of express trust law and equitable ownership is evident in the discussion of constructive trusts in the *Restatement of Restitution*. One example is the *Restatement*'s description of how a constructive trust is created. According to the *Restatement*, the genesis of a constructive trust is an event of unjust enrichment. The constructive

60. *E.g.*, City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 706 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1125 (4th Cir. 1986); N.S. Garrott & Sons v. Union Planters Nat'l Bank (*In re* N.S. Garrott & Sons), 772 F.2d 462, 467 (8th Cir. 1985); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1012, 1013-14 (5th Cir. 1985) (denying constructive trust claim on the facts); Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1136 (8th Cir. 1983), *cert. denied*, 469 U.S. 1207 (1985) (denying constructive trust claim on the facts); Heyman v. Kemp (*In re* Teltronics, Ltd.), 649 F.2d 1236, 1239 (7th Cir. 1981); RESTATEMENT OF RESTITUTION § 160 comment e (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 comment d (Tent. Draft No. 2, 1984); G. BOGERT & G. BOGERT, *supra* note 6, § 921, at 363, 364-65; 4 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1058, at 143 (S. Symons 5th ed. 1941); 5 A. SCOTT, *supra* note 6, § 472.4, at 3421-22 ("The beneficial interest is from the beginning in the person wronged."); Ames, *supra* note 24, at 514 (referring to constructive trust claimant as the "true owner"); Jennings & Shapiro, *supra* note 6, at 675-76; *see* 1 G. PALMER, *supra* note 2, § 2.15, at 190.

An equitable lien also takes on qualities of a property right, although the plaintiff's interest is more limited. *See* RESTATEMENT OF RESTITUTION § 162 comment d (1937).

61. On the nature of a trust beneficiary's interest as an interest in rem and a form of equitable property, see 2 A. SCOTT & W. FRATCHER, *supra* note 25, § 130; C. HUSTON, THE ENFORCEMENT OF DECREES IN EQUITY 87-114 (1915). A brief summary of opposing views appears in G. BOGERT & G. BOGERT, *supra* note 6, § 183; *see also* J.R. v. M.P., Y.B. 37 Henry 6, fo. 13, pl. 3 (1459), *translated & reprinted in* E. RE, CASES AND MATERIALS ON REMEDIES 46 (2d ed. 1987); G. BOGERT & G. BOGERT, *supra* note 6, § 861 (summarizing remedies).

62. *See* authorities cited *supra* note 60. The influence of notions of ownership on the operation of the constructive trust remedy can be seen in the *Restatement*. *See, e.g.*, RESTATEMENT OF RESTITUTION § 202 comments e, k, § 209 comment a (1937).

63. Professor Dawson warned against the association of constructive trusts with equitable ownership, saying the concept of equitable ownership has "seduced" courts and caused them to lose sight of the purpose of the remedy. J. DAWSON, *supra* note 2, at 32. Professor Palmer also criticizes the courts' tendency to incorporate substantive aspects of trust law into the definition and application of the constructive trust remedy. *See* 1 G. PALMER, *supra* note 2, §§ 1.4, 2.14(c), 2.15, at 190-91; *see also* D. DOBBS, *supra* note 8, § 4.3, at 241-42 (avoiding the concept of equitable ownership).

trust comes into being when the unjust enrichment first occurs and attaches from that time to the assets the defendant wrongfully acquired.[64] When the plaintiff later asserts a claim to those assets or their traceable products, the court may (or may not) enforce the constructive trust, depending primarily on the adequacy of legal remedies.[65]

This reasoning makes it possible for a constructive trust to exist, yet not to be enforceable between parties.[66] It also permits the conclusion that the claimant has automatic priority over general creditors. In the *Restatement*'s view, the plaintiff is the equitable owner of the property from the time of the unjust enrichment. Therefore, when the court grants a constructive trust decree, it is merely enforcing a preexisting property right, rather than establishing priority between the claimant and other creditors.[67]

The *Restatement*'s view of a constructive trust as a legal institution separate from its enforcement is an illusion by which the drafters explained away the impact of the remedy on creditors. A constructive trust arises only when the court decides to grant relief between the parties. Before that time, the defendant has property, and the plaintiff has a restitutionary claim based on principles of unjust enrichment. When the court imposes a constructive trust, it is making a decision to give the plaintiff a prior right to certain property, ahead of the defendant's creditors.[68]

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64. RESTATEMENT OF RESTITUTION § 160 & comments e, f, h (1937); *see* 5 A. SCOTT, *supra* note 6, § 462.4. The tentative draft of the *Restatement (Second)* appears to affirm this conception of constructive trusts. *See* RESTATEMENT (SECOND) OF RESTITUTION § 30 comment d, at 7 (Tent. Draft No. 2, 1984).

65. RESTATEMENT OF RESTITUTION § 160 comments e, f (1937); *see* 5 A. SCOTT, *supra* note 6, § 462.3. There is some debate on the availability of a constructive trust when a money remedy would provide adequate relief. *See* RESTATEMENT OF RESTITUTION § 160 comment e (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 472, at 37-40; 1 G. PALMER, *supra* note 2, § 2.18; 5 A. SCOTT, *supra* note 6, § 462.3; Banks, *supra* note 6, at 105-12; Jennings & Shapiro, *supra* note 6, at 674-78. Professor Palmer approaches the question from a remedial perspective, focusing on the relative utility of a constructive trust and other remedies. 1 G. PALMER, *supra* note 2, § 2.18. Others, influenced by the notion that a constructive trust claimant has a form of equitable interest in property, have argued that the adequacy of a damage remedy should not affect the claimant's right to a constructive trust. *See* Jennings & Shapiro, *supra* note 6, at 674-78; *supra* text accompanying notes 60-62.

66. RESTATEMENT OF RESTITUTION § 160 comment f, at 450 (1937).

67. *See* RESTATEMENT OF RESTITUTION § 202 comment e (1937); 5 A. SCOTT, *supra* note 6, § 508, at 3573, § 521, at 3650. *But see* J. DAWSON, *supra* note 2, at 32 (disapproving the notion of equitable ownership). Professor Scott is circular on the matter of creditors' rights and equitable ownership. At one point he asserts that creditors are not harmed by a constructive trust, because they have no right to "the claimant's property" (meaning the property subject to the restitutionary claim). 5 A. SCOTT, *supra* note 6, § 508, at 3513, § 521, at 3650. Yet, he reasons elsewhere that the constructive trust claimant's right to specific restitution in cases of insolvency is evidence that the claimant has an equitable interest in the property. *Id.* § 462.4, at 3422; *cf.* Jennings & Shapiro, *supra* note 6, at 674-77. Professors Jennings and Shapiro appear to reason that (1) because a constructive trust is enforceable in insolvency to the exclusion of general creditors, it must exist as a property interest from the time of unjust enrichment; and (2) because the equitable property interest exists from the time of unjust enrichment, the right to specific restitution should not depend on inadequacy of legal remedies.

68. This point is well expressed in Lacy, *supra* note 6, at 110-13.

Other writers have criticized the *Restatement*'s theory of the creation of a constructive trust.[69] Professor Bogert proposes an alternative analysis: a constructive trust is a remedy by which the court deems the defendant to have been a trustee from the date of the unjust enrichment.[70] The court creates the trust at the time of litigation, but its effect relates back to the original enrichment.[71] Professor Bogert's approach avoids treating the constructive trust as something independent of the court's decree, but it continues to incorporate express trust concepts in a way that can obscure the real decisions involved in granting the remedy. In particular, Professor Bogert appears to accept the view that a constructive trust decree does not create a new priority over creditors, because the plaintiff was (or is deemed to have been) the equitable owner of the property she claims from the time of the wrong.[72]

The courts' tendency to vest constructive trusts with substantive qualities suggests that they are reluctant to accept the responsibility of applying constructive trusts as a remedy. The decision to grant or deny a constructive trust is a decision about priority, which requires a judgment about the relative strength of different claims on assets. Courts may prefer to rely on concepts of equitable ownership and express trust, but in doing so, they separate the remedy from its underlying purpose of correcting unjust enrichment.[73]

III. BANKRUPTCY COURT DECISIONS

A. The General Approach

Most bankruptcy courts have accepted constructive trust claims, treating them as a form of nonbankruptcy property right that should be recognized in bankruptcy.[74] The general design of bankruptcy law is to

69. *E.g.*, 1 G. PALMER, *supra* note 2, § 1.4; Lacy, *supra* note 6, at 110-13.

70. G. BOGERT, TRUSTS § 77, at 287 (6th ed. 1987); *see* G. BOGERT & G. BOGERT, *supra* note 6, § 472, at 31.

71. G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 6-7, § 472, at 31-32; G. BOGERT, *supra* note 70, § 77, at 287.

72. G. BOGERT & G. BOGERT, *supra* note 6, § 921, at 363. Professor Bogert makes this statement with reference to the remedies of a beneficiary of an express trust, but he indicates that the same principle applies when the constructive trust remedy is applied to other cases of unjust enrichment. *Id.* at 364.

73. Professor Dawson questioned the justice of the constructive trust remedy as applied by the courts, particularly its effect on creditors. J. DAWSON, *supra* note 2, at 30-33 ("[W]e have created a monster.").

74. Cases in which the court either imposed a constructive trust or acknowledged the possibility of a constructive trust in bankruptcy include the following: Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135-36, 141-42 (1962) (subrogation and equitable lien); Cunningham v. Brown, 265 U.S. 1, 11 (1924); City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 704-06 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Turley v. Mahan & Rowsey, Inc. (*In re* Mahan & Rowsey, Inc.), 817 F.2d 682, 684 (10th Cir. 1987); Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 273-75 (D.C. Cir. 1987); Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1125 (4th Cir. 1986); N.S. Garrott & Sons v. Union Planters Nat'l Bank (*In re* N.S. Garrott & Sons), 772 F.2d 462, 467 (8th Cir. 1985); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1012-14 (5th Cir. 1985); Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1136

accept the legal rights of interested parties as they exist outside bank-

(8th Cir. 1984), *cert. denied*, 469 U.S. 1207 (1985) (with a possible exception for claims based on securities fraud); Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962, 968 (5th Cir. 1983); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965-66 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980); Elliott v. Bumb, 356 F.2d 749, 754 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966); Yonkers Bd. of Educ. v. Richmond Children's Center, Inc., 58 Bankr. 980, 982 (S.D.N.Y. 1986); United States Dep't of Energy v. Seneca Oil Co. (*In re* Seneca Oil Co.), 76 Bankr. 810, 813 (W.D. Okla. 1985); Reliance Ins. Co. v. Brown, 40 Bankr. 214, 217-18 (W.D. Mo. 1984); First Nat'l Bank v. Hurricane Elkhorn Coal Corp. II (*In re* Hurricane Elkhorn Coal Corp. II), 32 Bankr. 737, 739-40 (W.D. Ky. 1983), *aff'd*, 763 F.2d 188 (5th Cir. 1985); Harter v. Harter, Inc. (*In re* Harter, Inc.), 31 Bankr. 1015, 1019 (D. Kan. 1983); Elin v. Bushe (*In re* Elin), 20 Bankr. 1012, 1015-20 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983); *In re* Preston, 76 Bankr. 654, 656 (Bankr. C.D. Ill. 1987); American Hull Ins. Syndicate v. United States Lines, Inc. (*In re* United States Lines, Inc.), 79 Bankr. 542, 544-46 (Bankr. S.D.N.Y. 1987); McTevia v. Adamo (*In re* Atlantic Mortgage Corp.), 69 Bankr. 321, 328-30 (Bankr. E.D. Mich. 1987); Bistate Oil Co. v. Heston Oil Co. (*In re* Heston Oil Co.), 63 Bankr. 711, 714 (Bankr. N.D. Okla. 1986) (cautiously acknowledging the remedy); Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 790-91 (Bankr. E.D.N.Y. 1986) (excluding relief in mistake case); Neochem Corp. v. Behring Int'l, Inc. (*In re* Behring Int'l, Inc.), 61 Bankr. 896, 901-02, 907 (Bankr. N.D. Tex. 1986); Storage Technology Corp. v. Storage Technology Fin. Corp. (*In re* Storage Technology Corp.), 55 Bankr. 479, 484 (Bankr. D. Colo. 1985); Bavely v. Ft. Thomas Bellevue Bank (*In re* Triple A Coal Co.), 55 Bankr. 806, 813 (Bankr. S.D. Ohio 1985); Cook v. United States (*In re* Earl Roggenbuck Farms, Inc.), 51 Bankr. 913, 917 (Bankr. E.D. Mich. 1985); *In re* American Int'l Airways, Inc., 44 Bankr. 143, 146 (Bankr. E.D. Pa. 1984); Varon v. Salomon (*In re* Martin Fein & Co.), 43 Bankr. 623, 626 (Bankr. S.D.N.Y. 1984); Merrill v. Abbott (*In re* Independent Clearing House Co.), 41 Bankr. 985, 1000 (Bankr. D. Utah 1984), *aff'd in part and rev'd in part on other grounds sub nom.* Merrill v. Dietz (*In re* Universal Clearing House Co.), 62 Bankr. 118 (D. Utah 1986); Schifter v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508, 510-11 (Bankr. S.D. Fla. 1983); Country-Uptown Motel, Inc. v. PLM/Hotel-Motel Div., Inc. (*In re* PLM/Hotel-Motel Div., Inc.), 35 Bankr. 499, 502 (Bankr. E.D. Tenn. 1983); Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928, 931-32 (Bankr. M.D. Fla. 1983); *In re* Graham, 28 Bankr. 928, 931-32 (Bankr. N.D. Iowa 1983); Sommer v. Vermont Real Estate Inv. Trust (*In re* Vermont Real Estate Inv. Trust), 25 Bankr. 813, 816 (Bankr. D. Vt. 1982); U.S. Life Title Ins. Co. v. Lester (*In re* Fieldcrest Homes, Inc.), 18 Bankr. 678, 679 (Bankr. N.D. Ill. 1982); U.S. Life Title Ins. Co. v. Steinberg (*In re* Independence Land Title Corp.), 18 Bankr. 673, 674 (Bankr. N.D. Ill. 1982); Climax Molybdenum Co. v. Specialized Installers, Inc. (*In re* Specialized Installers, Inc.), 12 Bankr. 546, 553 (Bankr. D. Colo. 1981); Travelers Ins. Co. v. Angus (*In re* Angus), 9 Bankr. 769, 771 (Bankr. D. Or. 1981); Thunderbird Motor Freight Lines, Inc. v. Penn-Dixie Steel Corp. (*In re* Penn-Dixie Steel Corp.), 6 Bankr. 817, 824 (Bankr. S.D.N.Y. 1980), *aff'd*, 10 Bankr. 878 (S.D.N.Y. 1981). *See* 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 41.13, at 541-75 to 541-76. *But cf.* United States v. Randall, 401 U.S. 513, 515-17 (1971) (rejecting what appears to have been a constructive trust claim based on misappropriation from a statutory trust for withheld taxes).

The Bankruptcy Code and accompanying legislative history provide some support for the use of constructive trusts in bankruptcy proceedings. Section 541 of the Code defines "property of the estate." 11 U.S.C. § 541 (1982 & Supp. IV 1986). Subsection (d) provides:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage . . . sold by the debtor but as to which the debtor retains legal title to service . . . such mortgage . . . , becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

Id. § 541(d) (Supp. IV 1986); *see* 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶¶ 541.13, 541.24.

The House and Senate reports on § 541 refer at one point to constructive trusts, giving the example of insurance proceeds intended for payment of a debtor's medical bills but still held by the debtor at the filing of the bankruptcy petition. S. REP. NO. 989, 95th Cong., 2d Sess. 82, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5868; H.R. REP. NO. 595, 95th Cong., 1st Sess. 367, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6323. The basis for a constructive trust in this case is not clear. Normally, an unpaid doctor would have a simple contract claim against the debtor and would not have a restitution claim to proceeds of an insurance policy purchased by the debtor. *See* 10A G. COUCH, COUCH CYCLOPEDIA OF INSURANCE LAW § 41A:42 (R. Anderson 2d ed. M. Rhodes rev. vol. 1982); *cf.* 4 G. PALMER, *supra* note 2, §§ 21.1-21.7 (discussing three-party

ruptcy and provide a procedure for collecting and distributing the debtor's assets in accordance with those rights.[75] The Bankruptcy Code[76] stays individual debt collection actions and substitutes a collective proceeding under the supervision of a bankruptcy judge. Some incidents of nonbankruptcy rights necessarily are altered when creditors' claims are pooled for unified administration; but for the most part, the bankruptcy process is superimposed on a preexisting set of claims and interests.

Within this framework, bankruptcy courts have referred to state law, asking whether a claimant would be entitled to a constructive trust outside bankruptcy in a case between the claimant and the debtor.[77] If so, the bankruptcy courts generally equate the constructive trust claimant's rights against the debtor with equitable ownership: the claimant has an equitable interest in the property she claims, which survives the commencement of bankruptcy proceedings.[78] From this premise, it fol-

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cases in which one person may have a restitutionary claim to benefits another received from a third party). The authors of the House and Senate reports may have had in mind a case in which the debtor had assigned his right to proceeds to the doctor. In that situation, however, the doctor's interest in the insurance proceeds would be based on a consensual transaction, rather than the general principle of unjust enrichment.

Nevertheless, courts have cited the House and Senate reports as evidence that Congress intended to recognize constructive trust claims in bankruptcy. *E.g.*, Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1124-25 (4th Cir. 1986); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1013 n.9 (5th Cir. 1985); Yonkers Bd. of Educ. v. Richmond Children's Center, Inc., 58 Bankr. 980, 982 (S.D.N.Y. 1986); *In re* Auto-Train Corp., 53 Bankr. 990, 995 n.14 (D.D.C. 1985), *rev'd*, 810 F.2d 270 (D.C. Cir. 1987).

75. *See* Butner v. United States, 440 U.S. 48, 54-55 (1979); T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW ch. 2 (1986); Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 109-11 (1984); Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 956-59 (1981); Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 781 (1987); *see also* Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953) (discussing the extent to which federal courts can override state-created rights by application of principles of equitable subordination); Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 857-71 (1982) (justifying the recognition of nonbankruptcy entitlements in terms of the hypothetical bargain rational creditors would reach if bargaining costs were not prohibitive). Although these authors agree that bankruptcy does not require general displacement and reallocation of nonbankruptcy rights, they disagree on the purposes and scope of the bankruptcy process. Differing views of bankruptcy policy are discussed *infra* notes 255-59 and accompanying text.

76. 11 U.S.C. §§ 101-1330 (1982 & Supp. IV 1986).

77. *E.g.*, City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 702-07 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1126-27 (4th Cir. 1986); N.S. Garrott & Sons v. Union Planters Nat'l Bank (*In re* N.S. Garrott & Sons), 772 F.2d 462, 462-67 (8th Cir. 1985); Torres v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573, 1575-76 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1012, 1013-14 (5th Cir. 1985); Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied*, 469 U.S. 1207 (1985); Toys "R" Us, Inc. v. Esgro, Inc. (*In re* Esgro, Inc.), 645 F.2d 794, 797 (9th Cir. 1981); Rosenberg v. Collins, 624 F.2d 659, 663 (5th Cir. 1980); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 966 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980).

78. *E.g.*, City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 706-07 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Mid-Atlantic Supply, Inc. v. Three

lows that her claim to specific restitution has priority over claims of other creditors.[79] Further, courts often state that a constructive trust removes the assets to which it applies from the property of the bankruptcy estate, as defined in the Bankruptcy Code.[80] This means the property is not available for administrative use in the course of liquidation or reorganization. The trustee in bankruptcy, having only legal title with no beneficial interest, must turn over the property to the constructive trust claimant.[81]

Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1125 (4th Cir. 1986); N.S. Garrott & Sons v. Union Planters Nat'l Bank (*In re* N.S. Garrott & Sons), 772 F.2d 462, 467 (8th Cir. 1985); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1012 (5th Cir. 1985); Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied*, 469 U.S. 1207 (1985). *But see* Torres v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573, 1575-76 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986) (referring to state law, but applying the constructive trust as a remedy subject to federal bankruptcy policies).

A typical example is Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928 (Bankr. M.D. Fla. 1983). There, the debtor obtained an advance of funds from a bank by means of fraud, and the bank was able to identify the money among the debtor's assets in bankruptcy. The bankruptcy court found that under state law, in an action against the debtor, the bank would be entitled to a constructive trust. Therefore, the bank was entitled to recover the money from the debtor's trustee in bankruptcy, to the exclusion of other creditors. *Id.* at 931-32.

79. *E.g.*, Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135-36 (1962) (equitable lien); Cunningham v. Brown, 265 U.S. 1, 11 (1924); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980). All of the decisions implicitly assume that a successful constructive trust claim is prior to the claims of general creditors.

80. *E.g.*, Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136 (1962) (decided under former bankruptcy act); Cunningham v. Brown, 265 U.S. 1, 11 (1924) (decided under former bankruptcy act); City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 704-07 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Turley v. Mahan & Rowsey, Inc. (*In re* Mahan & Rowsey, Inc.), 817 F.2d 682, 684 (10th Cir. 1987); Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1125-26 (4th Cir. 1986); Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied*, 469 U.S. 1207 (1985); Heyman v. Kemp (*In re* Teltronics, Ltd.), 649 F.2d 1236, 1239 (7th Cir. 1981) (decided under former bankruptcy act); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980) (decided under former bankruptcy act). This is in part an interpretation of § 541(d) of the Bankruptcy Code, which provides that when the debtor has only legal title to property, equitable interests in the property are not included in the bankruptcy estate. 11 U.S.C. § 541(d) (Supp. IV 1986) (quoted and discussed *supra* note 74).

Some courts have refined their positions, stating that the debtor's legal title is property of the bankruptcy estate, but the beneficial right to the property is not property of the estate. *E.g.*, N.S. Garrott & Sons v. Union Planters Nat'l Bank (*In re* N.S. Garrott & Sons), 772 F.2d 462, 467 (8th Cir. 1985); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1012 (5th Cir. 1985); Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962, 967-68 (5th Cir. 1983).

81. *E.g.*, Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1126 (4th Cir. 1986); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1012 (5th Cir. 1985); Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962, 968 (5th Cir. 1983); Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928, 932 (Bankr. M.D. Fla. 1983); *see* N.S. Garrott & Sons v. Union Planters Nat'l Bank (*In re* N.S. Garrott & Sons), 772 F.2d 462, 467 (8th Cir. 1985) (debtor to "set aside and eventually pay over" funds subject to a constructive trust); Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1136 (8th Cir. 1984) (estate holds funds subject to a duty to convey).

In this respect, a successful constructive trust claimant is in a better position than a secured creditor. A creditor with a perfected security interest in property of the debtor is entitled to realize the value of her security interest in bankruptcy, but the automatic stay prevents her from enforcing her claim against the collateral during the course of administration. Meanwhile, the trustee in bank-

This pattern of decision reflects a misunderstanding of the remedial nature of constructive trusts. The courts are correct in referring to state law in the first instance to determine whether the claimant would be entitled to a constructive trust against the debtor. Their mistake has been to treat the claimant's state law remedy as a right of equitable ownership for purposes of distribution in bankruptcy. Once the court has taken that view of the constructive trust claim, it cannot reevaluate the equity of the remedy in the specific context of a contest between the constructive trust claimant and other creditors. A constructive trust is not a right of ownership, but an equitable remedy against unjust enrichment. Viewed as a remedy, it should depend on a determination of unjust enrichment between the claimant and the parties it affects. In most bankruptcy cases, the parties affected are unsecured creditors, and the constructive trust remedy should apply only when retention of property by the bankruptcy estate would result in an unjust enrichment of competing creditors.[82]

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ruptcy is authorized to use or sell the collateral, if the trustee provides "adequate protection" to the secured creditor. This delays the secured creditor's collection and can result in a loss of collateral value. *See* 11 U.S.C. §§ 361, 362, 363, 506(a) (1982 & Supp. IV 1986); 2 COLLIER ON BANKRUPTCY, *supra* note 39, ¶¶ 361.01-361.02, 363.03-363.07; T. JACKSON, *supra* note 75, at 83-88; Baird & Jackson, *supra* note 75, at 97. *But cf.* Warren, *supra* note 75, at 809-10 (identifying advantages bankruptcy may provide to secured creditors). Further, a reorganization debtor can reinstate a defaulted secured loan, and can alter payment terms through its plan of reorganization. *See* 11 U.S.C. §§ 1124(2), 1129(b)(2)(A) (1982 & Supp. IV 1986); 5 COLLIER ON BANKRUPTCY, *supra* note 37, ¶¶ 1124.03[2], 1129.03[4][a]-[c] (L. King 15th ed. 1988); Jackson, *supra* note 75, at 879-83. In contrast, the cases cited above suggest that a constructive trust claimant is entitled to an immediate turnover of the property she claims. On the other hand, courts that consider the debtor's legal title to be property of the estate might allow the trustee to use or sell the property subject to the requirement of adequate protection. *But see* United States v. Whiting Pools, Inc., 462 U.S. 198, 204 n.8, 205 n.10 (1983) (indicating property in which the debtor has only legal title is wholly excluded from the estate); Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962, 968 (5th Cir. 1983) ("[P]erhaps, the debtor in possession's sole permissible administrative act . . . would be to pay over . . . the sums due.").

Most often the object of a constructive trust claim is to obtain property in the hands of the bankruptcy trustee. In a number of cases, however, constructive trusts have been asserted defensively. This occurs when the bankruptcy trustee brings an action against a claimant who obtained voluntary reimbursement from the debtor prior to bankruptcy, and seeks to recover the debtor's payment as a preferential transfer or fraudulent conveyance. If the claimant would have been entitled to a constructive trust but for the voluntary payment, the claimant may argue that there was no fraudulent or preferential transfer of the debtor's property, because the property was subject to a constructive trust. *See, e.g.*, Cunningham v. Brown, 265 U.S. 1, 7 (1924); Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 273 (D.C. Cir. 1987); Rosenberg v. Collins, 624 F.2d 659, 662 (5th Cir. 1980); Merrill v. Dietz (*In re* Independent Clearing House Co.), 62 Bankr. 118, 121-22 (D. Utah 1986); Gray v. Fill (*In re* Fill), 82 Bankr. 200, 202-03 (Bankr. S.D.N.Y. 1987); Faircloth v. Paul (*In re* International Gold Bullion Exch., Inc.), 60 Bankr. 261, 262-63 (Bankr. S.D. Fla. 1986); Edmondson v. Bradford-White Corp. (*In re* Tinnel Traffic Servs., Inc.), 41 Bankr. 1018, 1020 (Bankr. M.D. Tenn. 1984). This argument has not fared well, especially when the constructive trust claim arises out of a fraudulent investment scheme in which the debtor defrauded many people and most were not repaid. Courts are reluctant to favor one claimant over others whose claims are identical, and they are likely to deny the constructive trust claim on the ground that the claimant has not sufficiently traced the property subject to her claim. *E.g.*, Cunningham v. Brown, 265 U.S. 1, 11-13 (1924). *See infra* notes 84-97 and accompanying text.

82. Professor Lacy has expressed a similar idea. He suggests that at least in Ponzi-type cases, the court should look beyond the relative equities of the constructive trust claimant and the debtor to consider the balance of interests between the claimant and other parties who will be affected adversely by the constructive trust. Lacy, *supra* note 6, at 111-12; *see also* J. DAWSON, *supra* note 2,

B. Some Limits on the Operation of Constructive Trusts in Bankruptcy

A number of courts have imposed restrictions that limit the effect of constructive trusts in bankruptcy. Apparently, the courts have perceived that the constructive trust remedy should not apply against competing creditors exactly as it would apply against the debtor.[83] But for the most part, they have responded by imposing technical restrictions on the operation of constructive trusts in bankruptcy, without reconsidering the question of unjust enrichment in the context of a competition for assets between the constructive trust claimant and other creditors.

1. Special Tracing Rules

One line of cases limits the constructive trust remedy in bankruptcy by imposing stricter tracing requirements that prevent the claimant from tracing into commingled funds. The United States Supreme Court developed this approach in *Cunningham v. Brown*,[84] a bankruptcy case that arose in the aftermath of the original "Ponzi scheme." The debtor (Ponzi) had solicited loans from investors, promising to pay each investor 150% of the loan amount at the end of ninety days, and to repay any loan in full on demand. The money for these payments was to come from Ponzi's trading in international postal coupons. In fact, the postal coupon enterprise was entirely fictitious; Ponzi simply deposited incoming funds in his bank account and used proceeds of later notes to repay earlier notes. Eventually, news leaked and the scheme collapsed.[85]

Ponzi's trustee in bankruptcy sued a number of investors who had called their loans and obtained repayment before bankruptcy, asserting that the prebankruptcy payments were voidable preferences.[86] The defendants argued the repayments were not preferential transfers of the debtor's property, because the debtor held their funds subject to a constructive trust.[87] Assuming the defendants had rescinded their investment agreements with the debtor, a constructive trust would have been

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at 32 (criticizing inflexible applications of the constructive trust remedy); D. DOBBS, *supra* note 8, § 4.3, at 244-45, 246 (considering interests of creditors with respect to a windfall in excess of claimant's loss); 1 G. PALMER, *supra* note 2, § 2.14(c), at 185-86 (comparing constructive trust claims to claims of creditors).

83. Some courts have expressed a general reluctance to place the burden of the remedy on other creditors. *See, e.g.*, Elliott v. Frontier Properties/LP (*In re* Lewis W. Shurtleff, Inc.), 778 F.2d 1416, 1419-20 (9th Cir. 1985); Torres v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573, 1575-78 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986); Chbat v. Tleel (*In re* Tleel), 79 Bankr. 883, 886 (Bankr. 9th Cir. 1987); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 40 (Bankr. D. Kan. 1986); Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 792 (Bankr. E.D.N.Y. 1986); Neochem Corp. v. Behring Int'l, Inc. (*In re* Behring Int'l, Inc.), 61 Bankr. 896, 902-03 (Bankr. N.D. Tex. 1986).

84. 265 U.S. 1 (1924).

85. *Id.* at 7-9.

86. *Id.* at 7.

87. *Id.* at 2-4.

an appropriate remedy outside bankruptcy, based on fraud.[88] Further, widely accepted nonbankruptcy tracing rules allowed a constructive trust claimant to trace the claim into a commingled bank account to the extent of the lowest balance of the account between the time of deposit and the time of trial.[89] Under these tracing rules, the defendants in *Cunningham v. Brown* would have been entitled to constructive trusts on Ponzi's funds in amounts at least equal to the prebankruptcy payments they received. Nevertheless, the Court held the defendants had not traced their claims sufficiently to establish priority over other claimants in the case.[90] The Court reasoned that while tracing rules allowing the claimant to trace to the lowest intermediate balance of a commingled fund might produce an equitable result in a case between victim and wrongdoer, the prevailing tracing rules were not appropriate in the context of Ponzi's bankruptcy.[91] In the Court's view, this was "a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt [sic] law."[92]

Cunningham v. Brown did not rule out the use of contructive trusts in bankruptcy; it held only that the claimants could not rely on a constructive trust unless they traced their claims to specific assets. Further, the Court emphasized that most creditors in Ponzi's bankruptcy proceeding were victims of the same fraud. If the bankruptcy court recognized a constructive trust claim for the defendants, their constructive trust would reduce the recoveries of other investors whose claims were identical except that the defendants had been paid before the bankruptcy and the others had not.[93] Despite the Court's broad statement that equality is equity in bankruptcy, it left open the possibility that a constructive trust remedy could be appropriate in other situations.[94]

A number of lower courts have applied the tracing restriction of *Cunningham v. Brown*, both in cases of fraud against multiple investors and in cases in which a single restitutionary claimant is competing with general creditors.[95] Courts sometimes explain the limitation in terms of

88. In the first part of the opinion, the Court determined that the defendants had not rescinded their agreements with the debtor; they had simply exercised a right under the terms of the agreements to demand repayment without interest in advance of maturity. Therefore, they had elected to affirm the agreement and could not rely on a remedy of rescission and restitution. *Id.* at 10-11; *see* D. DOBBS, *supra* note 8, § 1.5, at 17-18 (discussing election of remedies by conduct suggesting affirmance of a contract). The Court went on, however, to discuss the possibility of a constructive trust in the debtor's bankruptcy, assuming there had been an effective rescission. *Cunningham*, 265 U.S. at 11.

89. *See Cunningham*, 265 U.S. at 12. Standard rules for tracing into commingled funds are discussed *supra* notes 52-58 and accompanying text.

90. *Cunningham*, 265 U.S. at 11.

91. *Id.* at 13.

92. *Id.*

93. *Id.*

94. *Id.* at 11.

95. *E.g.*, Toys "R" Us, Inc. v. Esgro, Inc. (*In re* Esgro, Inc.), 645 F.2d 794, 797-98 (9th Cir. 1981) (single claimant asserting a statutory constructive trust on general assets); Rosenberg v. Collins, 624 F.2d 659, 663-64 (5th Cir. 1980) (multiple claimants); Wisconsin v. Reese (*In re* Kennedy &

state and federal law: although state law governs the underlying basis of a constructive trust claim, the necessity of tracing specific funds is a federal question affected by a federal bankruptcy policy of equal distribution.[96] Nevertheless, the tracing decisions accept the premise that if the claimant would be entitled to a constructive trust against the debtor under governing state law, and she can identify specific assets (or their proceeds) that are subject to her claim, she is entitled to priority in those assets.[97]

2. *Strong Arm Powers and Related Issues*

Another possible limit on the operation of constructive trusts in bankruptcy comes from the strong arm provisions of the Bankruptcy Code. Under section 544 of the Bankruptcy Code, a trustee in bankruptcy assumes the status of a creditor holding a judgment lien and a bona fide purchaser of real property, as of the date of the debtor's bankruptcy petition.[98] This means the trustee can set aside any interest that would be subject to the rights of a lien creditor or a bona fide purchaser of real property under state law.[99]

Courts have differed on the applicability of section 544 to constructive trust claims. Several cases hold that section 544 has no effect on a

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Cohen, Inc.), 612 F.2d 963, 965-66 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980) (multiple claimants); Elliott v. Bumb, 356 F.2d 749, 754-55 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966) (single claimant asserting a statutory constructive trust on general assets); Merrill v. Abbott (*In re* Independent Clearing House Co.), 41 Bankr. 985 (Bankr. D. Utah 1984), *aff'd sub nom.* Merrill v. Dietz (*In re* Universal Clearing House Co.), 62 Bankr. 118 (D. Utah 1986) (multiple claimants); Lawless v. Anderson (*In re* Moore), 39 Bankr. 571, 573-74 (Bankr. M.D. Fla. 1984) (multiple claimants); Schifter v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508, 510-15 (Bankr. S.D. Fla. 1983).

96. *E.g.*, Toys "R" Us v. Esgro, Inc. (*In re* Esgro, Inc.), 645 F.2d 794, 797-98 (9th Cir. 1981); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965-66 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980); Elliott v. Bumb, 356 F.2d 749, 754 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966) (referring to a statutory constructive trust); Reliance Ins. Co. v. Brown, 40 Bankr. 214, 218 (W.D. Mo. 1984); Schifter v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508, 512-13 (Bankr. S.D. Fla. 1983).

97. *E.g.*, *Cunningham*, 265 U.S. at 11; Toys "R" Us v. Esgro, Inc. (*In re* Esgro, Inc.), 645 F.2d 794, 797 (9th Cir. 1981); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 966 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980); Reliance Ins. Co. v. Brown, 40 Bankr. 214, 218 (W.D. Mo. 1984); Bistate Oil Co. v. Heston Oil Co. (*In re* Heston Oil Co.), 63 Bankr. 711, 714 (Bankr. N.D. Okla. 1986); Merrill v. Abbott (*In re* Independent Clearing House Co.), 41 Bankr. 985, 1000 (Bankr. D. Utah 1984), *aff'd sub nom.* Merrill v. Dietz (*In re* Universal Clearing House Co.), 62 Bankr. 118 (D. Utah 1986).

98. 11 U.S.C. § 544(a) (Supp. IV 1986). The trustee also has the rights of a creditor holding an execution that is returned unsatisfied. *Id.* § 544(a)(2).

99. On the purposes and operation of § 544(a), see 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶¶ 544.01-544.02; T. JACKSON, *supra* note 75, at 70-79; Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 732-42, 750-56 (1984); McCoid, *Bankruptcy, Avoiding Powers, and Unperfected Security Interests*, 59 AM. BANKR. L.J. 175 (1985). The trustee's status as lien creditor, execution creditor, and bona fide purchaser of real property does not depend on the presence of any such creditor or purchaser among the actual claimants to the estate. The trustee is given an additional power to avoid transfers or obligations that an existing unsecured creditor of the debtor could avoid outside bankruptcy. 11 U.S.C. § 544(b) (1982); *see* 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 544.03.

constructive trust claim, because the property subject to the claim is outside the scope of the bankruptcy estate.[100] The leading case for this view is *Vineyard v. McKenzie (In re Quality Holstein Leasing)*,[101] a case of fraud. The court began its analysis with section 541 of the Bankruptcy Code, which defines "[p]roperty of the estate" and excludes from that definition any outstanding equitable interests in property to which the debtor holds legal title.[102] The court assumed that because the claimant (a bank) was entitled to a constructive trust under state law, it was the equitable owner of the property at issue. Therefore, section 541 removed the property from the bankruptcy estate. Further, because the bank's equitable interest in the property was excluded from the estate, the bankruptcy trustee could not avoid the bank's constructive trust claim under section 544. In other words, section 541 preempts the trustee's strong arm powers, because "Congress did not mean to authorize a bankruptcy estate to benefit from property the debtor did not own."[103]

Other courts have disagreed with this reasoning, holding that section 544 applies to constructive trust claims and permits the trustee to avoid such a claim if a lien creditor or bona fide purchaser of real estate would have priority over the constructive trust claimant under state law.[104] These courts take the view that sections 541 and 544 are separate and complimentary sources of rights for the trustee. Section 541 defines what property rights the bankruptcy trustee acquires as successor to the debtor, while section 544 allows the trustee, as representative of general creditors, to reach additional interests. Thus, even though equitable interests in property initially are excluded from the estate under section 541, they can be reclaimed for the estate through the avoidance powers

100. Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1013-14 (5th Cir. 1985); McTevia v. Adamo (*In re* Atlantic Mortgage Corp.), 69 Bankr. 321, 330 (E.D. Mich. 1987); City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 64 Bankr. 702, 708-09 (S.D. Fla. 1986), *aff'd on other grounds with reservations*, 828 F.2d 699 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Bavely v. Ft. Thomas Bellevue Bank (*In re* Triple A Coal Co.), 55 Bankr. 806, 813 (Bankr. S.D. Ohio 1985); Cook v. United States (*In re* Earl Roggenbuck Farms, Inc.), 51 Bankr. 913 (Bankr. E.D. Mich. 1985); U.S. Life Title Ins. Co. v. Lester (*In re* Fieldcrest Homes, Inc.), 18 Bankr. 678, 679 (Bankr. N.D. Ill. 1982). In the majority of cases involving constructive trust claims in bankruptcy, this issue has not arisen.

101. 752 F.2d 1009 (5th Cir. 1985).

102. 11 U.S.C. § 541(d) (Supp. IV 1986); *see supra* note 74.

103. *Quality Holstein*, 752 F.2d at 1013.

104. *E.g.*, Chbat v. Tleel (*In re* Tleel), 79 Bankr. 883, 887 (Bankr. 9th Cir. 1987); Eads v. Probasco (*In re* Eads), 69 Bankr. 730, 735 (Bankr. 9th Cir. 1986); McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1009-10 (M.D. Tenn. 1983); Elin v. Busche (*In re* Elin), 20 Bankr. 1012, 1016-20 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983) (§ 544 applies, but claimant prevailed); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 39-42 (Bankr. D. Kan. 1986); Faircloth v. Paul (*In re* International Gold Bullion Exch., Inc.), 60 Bankr. 261, 264 (Bankr. S.D. Fla. 1986); Storage Technology Corp. v. Storage Technology Fin. Corp. (*In re* Storage Technology Corp.), 55 Bankr. 479, 484 (Bankr. D. Colo. 1985) (§ 544 applies, but claimant prevailed); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 903-05 (Bankr. C.D. Cal. 1984); Clark v. Kahn (*In re* Dlott), 43 Bankr. 789, 792-93 (Bankr. D. Mass. 1983); *see* City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 704-07 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988) (summarizing positions, but declining to decide the issue).

defined in section 544.[105]

The first view, that the trustee cannot avoid a constructive trust claim under section 544 because section 541 excludes the affected property from the bankruptcy estate, is both a misreading of the Bankruptcy Code and a misconception of constructive trusts. To say that section 541 preempts the application of section 544 is illogical, because the principal function of section 544 is to reclaim interests of third parties that initially were not within the definition of property of the estate. More fundamentally, the premise that section 541 excludes constructive trust property from the estate is based on a characterization of the claimant as the equitable owner of the property. As discussed earlier,[106] equitable ownership merely states the results of the constructive trust remedy, if granted. It should not enter into the court's decision whether to allow or deny a constructive trust in bankruptcy.

On the other hand, application of the section 544 strong arm powers to constructive trusts is not inevitable. A constructive trust is a judicial remedy imposed to give relief against unjust enrichment. The primary function of section 544 is to deny effect to transfers of property or security interests when the creditor has not adequately recorded or perfected her interest under state law procedures. Whether the strong arm powers also should apply to the remedial decision to grant a constructive trust requires consideration of the purpose and policy of section 544.[107]

Traditional analysis of the strong arm powers holds that their primary purpose is to invalidate "secret liens."[108] The policy against secret

105. *E.g.*, McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1009-10 (M.D. Tenn. 1983); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 39 (Bankr. D. Kan. 1986).

106. *See supra* notes 59-73 and accompanying text.

107. Although § 544 incorporates state rules of priority, the policy of state law is not at stake in deciding whether the strong arm powers of a bankruptcy trustee should apply to constructive trusts. Applicable state rules incorporate equitable and commercial considerations between a constructive trust claimant and a lien creditor or bona fide purchaser of real property. *See supra* note 34 (discussing reasons for the priority of a bona fide purchaser over a constructive trust claimant). State priority rules do not contemplate the situation created by § 544, in which a bankruptcy trustee assumes the position of a hypothetical lien creditor and a hypothetical bona fide purchaser of real property on behalf of general creditors. *See* McCoid, *supra* note 99, at 190-92.

108. *See* City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 704 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Research-Planning, Inc. v. Segal (*In re* First Capital Loan Corp.), 60 Bankr. 915, 918 (Bankr. D. Utah 1986); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984); REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. 1, at 18 (1973); 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 544.01, at 544-2 to 544-3; T. JACKSON, *supra* note 75, at 76 & n.13; Kennedy, *Secured Creditors Under the Bankruptcy Reform Act*, 15 IND. L. REV. 477, 483 (1982); Morris, *Bankruptcy Law Reform: Preferences, Secret Liens, and Floating Liens*, 54 MINN. L. REV. 737, 740 (1970) (discussing predecessors to present § 544(a)).

Professor Jackson rejects this explanation of § 544. In his view, a policy against secret liens is not a proper bankruptcy policy, because it does not relate to the special nature of bankruptcy as a collective method of debt collection. T. JACKSON, *supra* note 75, at 77. He explains the strong arm powers as a reflection of the practical position of competing parties outside bankruptcy in the race to collect debts. T. JACKSON, *supra* note 75, at 70-79; Jackson, *supra* note 99, at 732-42. An un-

liens appears to arise from a combination of concerns, including both ostensible ownership and the possibility of collusion between the debtor and the claimant to conceal encumbrances from other creditors.[109] Viewed in this light, constructive trusts are not a primary target of section 544. A constructive trust claim is an unrecorded claim to property, but it does not raise the possibility of fraudulent concealment, because it is not a consensual arrangement. The constructive trust remedy applies without regard to the debtor's intent, and usually against his intent.[110]

In the absence of any potential for collusion and fraud, creditor reliance alone is not a powerful reason for avoiding the constructive trust claimant's rights in favor of unsecured creditors. Creditors who extend credit on an unsecured basis assume the risk of subsequent encumbrances on or conveyances of the debtor's property.[111] At least in the case of a

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perfected interest in property is superior to the claim of an unsecured creditor under state law. But if a lien creditor could defeat the unperfected interest, the unsecured creditor could prevail at any time by obtaining a judgment lien on the property. Therefore, when individual collection activities are stayed by the filing of a bankruptcy petition, it is appropriate to equalize the rights of the unperfected secured claimant and those of general creditors by vesting the bankruptcy trustee with the rights of a lien creditor. T. JACKSON, *supra* note 75, at 70-75; Jackson, *supra* note 99, at 732-36.

Professor Jackson's view points to the conclusion that § 544 should apply to constructive trusts: if the claimant would lose to a lien creditor under state law, the bankruptcy court should deny the constructive trust because unsecured creditors might have trumped the constructive trust claim prior to bankruptcy by obtaining liens. But it is difficult to apply this reasoning in defense of the trustee's status as a bona fide purchaser, which is the power most likely to affect constructive trust claims. *See infra* notes 113-15 and accompanying text. On this point, Professor Jackson suggests that the bona fide purchaser provision may be a fair approximation of state law entitlements if state law permits a general creditor to defeat the holder of an unrecorded deed by obtaining a judgment lien and completing an execution sale of the property to a bona fide purchaser. T. JACKSON, *supra* note 75, at 78; Jackson, *supra* note 99, at 740-41.

A good analysis of the history and objectives of the strong arm powers appears in McCoid, *supra* note 99. Professor McCoid notes that the legislative history to the strong arm provisions expresses hostility toward secret liens, but he does not find this a persuasive reason for § 544. Secret liens have no bearing on the effectiveness of a collective proceeding, and "[t]here is reason . . . to doubt the wisdom of a general policy against secret liens." *Id.* at 187-90. Professor McCoid also suggests that § 544 cannot be justified in terms of the trustee's representation of general creditors, because it does not accurately reflect the position of general creditors under state law. *Id.* at 190-92. On this point, his analysis differs from that of Professor Jackson.

109. In one case involving a constructive trust claim, the bankruptcy court discussed the policy against secret liens at length. Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899 (Bankr. C.D. Cal. 1984). The court stated that by invalidating unrecorded interests in property, § 544 inhibits fraudulent concealment of encumbrances and protects creditors' reliance on the debtor's title to assets, which is "essential to a dynamic commercial economy." *Id.* at 904. The court was somewhat reluctant to deny a constructive trust claim based on fraud in the absence of evidence that creditors had relied on the debtor's apparent title, but it felt the evils of an unrecorded claim to property must be presumed under § 544. "Evidently, we believe both reliance and fraud to be so likely that we do not put creditors to the expense and inconvenience of proof." *Id.* The paragraphs to follow in the text suggest that this presumption is not appropriate in the case of a constructive trust claim.

110. G. BOGERT & G. BOGERT, *supra* note 6, § 471, at 7; 5 A. SCOTT, *supra* note 6, § 462.1, at 3415.

111. Professor McCoid makes this point. McCoid, *supra* note 99, at 190; *see* Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 62-64 (1983) (arguing that the notice filing system of the Uniform Commercial Code has little utility for unsecured creditors and is primarily for the protection of competing secured creditors); *cf.* Baird & Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 175, 194 (discuss-

business debtor, unsecured creditors are more likely to rely on the debtor's ability to generate income than on his possession of specific assets. Further, if courts properly understand and apply the constructive trust as an equitable remedy against unjust enrichment, creditors' reliance on the debtor's apparent title can be addressed through the defenses of laches and estoppel.[112]

Assuming the primary purpose of the strong arm powers is to deny effect to misleading and collusive activities between the debtor and transferees of property interests, federal policy does not require the application of section 544 to constructive trust claims. The best approach is to treat the imposition of a constructive trust as a remedial issue for the court, independent of the operation of section 544. The court can determine the constructive trust claimant's priority in relation to other creditors according to principles of unjust enrichment, applied with reference to the effect of the constructive trust remedy in bankruptcy.

In any event, application of section 544 to constructive trust claims does not always win the case for the bankruptcy trustee. Section 544 incorporates priorities fixed by state law, which often favor the constructive trust claimant. With respect to personal property, the prevailing rule of priority outside bankruptcy holds that a judgment lien is subject to a constructive trust or equitable lien on specific property.[113] As a result, the constructive trust claimant is likely to prevail despite section 544. With respect to real property, the trustee has the status of a bona fide purchaser, who normally takes free of constructive trust claims under state law.[114] Even so, most bankruptcy courts hold that the

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ing ostensible ownership in terms of its effects on secured creditors). *But see* Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing,"* 47 IOWA L. REV. 289, 289 (1962) (suggesting that filing requirements are for protection of unsecured creditors).

112. *See* 5 A. SCOTT, *supra* note 6, § 481.1 (discussing laches). *See generally* D. DOBBS, *supra* note 8, § 2.3, at 42-44. Laches and estoppel are discussed in more detail *infra* notes 252-54 and accompanying text.

113. RESTATEMENT OF RESTITUTION § 473 comment j (1937); *see* G. BOGERT & G. BOGERT, *supra* note 6, § 887, at 197-98; 46 AM. JUR. 2D *Judgments* § 290 (1969) (judgment lien is generally subject to equitable claims to specific property); *see also* City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 706 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988) (interpreting Florida law); Storage Technology Corp. v. Storage Technology Fin. Corp. (*In re* Storage Technology Corp.), 55 Bankr. 479, 484 (Bankr. D. Colo. 1985) (Colorado law); Lauerman, *supra* note 6, at 425 & n.8 (North Carolina law). The reason usually given for the priority of a constructive trust claimant over a judgment creditor is that the judgment creditor does not give value for a judgment lien and is not in the position of a bona fide purchaser. *See* RESTATEMENT OF RESTITUTION § 473 comment j (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 887, at 197-98; 46 AM. JUR. 2D *Judgments* § 290 (1969). The reasoning of the *Restatement* is somewhat inconsistent on this point. A separate provision states that if the wrongdoer transfers property subject to a constructive trust claim to a creditor in satisfaction of an antecedent debt, the transfer is a transfer for value that ends the claimant's right to trace the property. RESTATEMENT OF RESTITUTION § 173(2) & comment l (1937).

114. RESTATEMENT OF RESTITUTION § 172 (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 881, at 159; D. DOBBS, *supra* note 8, § 4.7, at 281-83; 5 A. SCOTT, *supra* note 6, § 474. Constructive trust claims and other interests in real property for which no recording procedure is available under state law may be outside the reach of the bankruptcy trustee's powers as a bona fide purchaser

trustee's position as a bona fide purchaser is subject to state law standards of constructive notice. Circumstances such as possession by the constructive trust claimant may establish constructive notice of the equitable claim and prevent the trustee from avoiding the interest under section 544.[115]

A second group of cases should be mentioned, in which bankruptcy courts have focused on the point at which the constructive trust "arises" under state law. If a trust arises at the time of the wrong, it is effective in bankruptcy, but if it does not arise until the entry of a decree, the claim to specific restitution must fail.[116] This time-of-creation analysis is related to the view that section 541 of the Bankruptcy Code removes property subject to a constructive trust claim from the bankruptcy estate.[117] Section 541 excludes equitable interests in property if, "as of the commencement of the [bankruptcy] case," the debtor held only bare legal title to the property.[118] Therefore, if the constructive trust does not exist

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of real property. Section 544(a)(3) enables the trustee to avoid a transfer or obligation that is voidable by "a bona fide purchaser of real property . . . against whom applicable law permits such transfer to be perfected." 11 U.S.C. § 544(a)(3) (1982). Arguably, Congress did not intend this clause to apply against interests that can only be perfected by the entry of a decree. Courts, however, have not made this distinction. *See* authorities cited *infra* note 115.

115. Although the debtor's knowledge of the constructive trust claim is not imputed to the bankruptcy trustee as bona fide purchaser, the trustee is charged with notice of any facts existing at the date of the bankruptcy petition that would provide constructive notice to a purchaser under state law. *See, e.g.*, Eads v. Probasco (*In re* Eads), 69 Bankr. 730, 733-34 (Bankr. 9th Cir. 1986) (finding no constructive notice); Harter v. Harter, Inc. (*In re* Harter, Inc.), 31 Bankr. 1015, 1020-21 (D. Kan. 1983) (finding no constructive notice); McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1007 (M.D. Tenn. 1983) (finding constructive notice); Elin v. Busche (*In re* Elin), 20 Bankr. 1012, 1016-21 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983) (finding constructive notice); Clark v. Kahn (*In re* Dlott), 43 Bankr. 789, 792-96 (Bankr. D. Mass. 1983) (finding no constructive notice); *see* Lancaster v. Key, 24 Bankr. 897, 898-99 (E.D. Tenn. 1982) (vendee in possession under unrecorded deed defeats bankruptcy trustee).

For example, in *Elin v. Busche* the debtor had given the claimant (who at the time was his wife) a deed that was intended to convey his half interest in their house to her, but by its terms conveyed only curtesy rights. The court held that § 544 was applicable to the wife's constructive trust claim. The wife prevailed, however, because the recorded deed of curtesy rights (which was inherently inconsistent with the husband's interest as a tenant by entirety) would give constructive notice of the error to a purchaser of the property. *Elin*, 20 Bankr. at 1016-21.

116. *E.g.*, City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 701-04 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); McTevia v. Adamo (*In re* Atlantic Mortgage Corp.), 69 Bankr. 321, 328, 330 (Bankr. E.D. Mich. 1987); Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 790-91 (Bankr. E.D.N.Y. 1986); Research-Planning, Inc. v. Segal (*In re* First Capital Mortgage Loan Corp.), 60 Bankr. 915, 918-20 (Bankr. D. Utah 1986); Edmondson v. Bradford-White Corp. (*In re* Tinnell Traffic Servs., Inc.), 41 Bankr. 1018, 1021 & n.2 (Bankr. M.D. Tenn. 1984); Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928, 932 (Bankr. M.D. Fla. 1983); *see* Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1014 & n.10 (5th Cir. 1985) (constructive trust effective in bankruptcy if it attaches before bankruptcy).

117. *See* Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1014 n.10 (5th Cir. 1985); City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 64 Bankr. 702, 705 (S.D. Fla. 1986), *aff'd*, 828 F.2d 699 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); McTevia v. Adamo (*In re* Atlantic Mortgage Corp.), 69 Bankr. 321, 330 (Bankr. E.D. Mich. 1987); Research-Planning, Inc. v. Segal (*In re* First Capital Mortgage Loan Corp.), 60 Bankr. 915, 920 (Bankr. D. Utah 1986).

118. 11 U.S.C. § 541(d) (Supp. IV 1986).

until the entry of a decree, the exclusion can not apply.

Most often, courts have decided the time-of-creation issue in favor of the constructive trust claimant, adopting the view of the *Restatement of Restitution* that a constructive trust comes into existence when an unjust enrichment occurs. From that time forward, the claimant has an equitable interest in the specific property and its products.[119] As discussed earlier, the *Restatement*'s view of the time of creation of a constructive trust confuses the constructive trust remedy with substantive trust law.[120] A constructive trust is not a property right from the time of the wrong; it is a remedy granted by the court. It does not follow, however, that constructive trust claims must be denied in bankruptcy. The time-of-creation cases assume that the status of a constructive trust claimant in bankruptcy depends on whether the claimant has a preexisting right of equitable ownership under state law, so that the property claimed is outside the scope of the bankruptcy estate. In doing so, they lose sight of the fact that the constructive trust is not a right of ownership, but a remedy against unjust enrichment. The claimant's position should depend on her claim of unjust enrichment, viewed in the context of bankruptcy. The time of creation is a false issue that should not enter into the courts' analyses.[121]

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119. *See, e.g.*, City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699, 701-04 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 791 (Bankr. S.D.N.Y. 1986); Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928, 932 (Bankr. M.D. Fla. 1983). *But see* Research-Planning, Inc. v. Segal (*In re* First Capital Mortgage Loan Corp.), 60 Bankr. 915, 919 (Bankr. D. Utah 1986) (constructive trust arises at time of decree under Utah law); Edmondson v. Bradford-White Corp. (*In re* Tinnell Traffic Servs., Inc.), 41 Bankr. 1018, 1021 (Bankr. M.D. Tenn. 1984) (constructive trust arises at time of decree under Tennessee law); *cf.* American Hull Ins. Syndicate v. United States Lines, Inc. (*In re* United States Lines, Inc.), 79 Bankr. 542, 546 & n.2, 551 (Bankr. S.D.N.Y. 1987) (not deciding the issue of timing, but refusing to recognize a constructive trust as a prepetition interest for the purpose of superpriority after the funds were dissipated in the bankruptcy proceeding).

Several opinions indicate that a constructive trust can be sustained under Professor Bogert's view, which holds that a constructive trust arises when a decree is entered, but the claimant's rights relate back to the time of the wrong. *See* Reliance Ins. Co. v. Brown, 40 Bankr. 214, 218 (W.D. Mo. 1984); McTevia v. Adamo (*In re* Atlantic Mortgage Corp.), 69 Bankr. 321, 328 (Bankr. E.D. Mich. 1987); *supra* text accompanying notes 69-72.

120. *See* 1 G. PALMER, *supra* note 2, § 1.4; *supra* notes 59-68 and accompanying text. Some of the courts have made this point. *E.g.*, Research-Planning, Inc. v. Segal (*In re* First Capital Mortgage Corp.), 60 Bankr. 915, 919 (Bankr. D. Utah 1986); Edmondson v. Bradford-White Corp. (*In re* Tinnell Traffic Servs., Inc.), 41 Bankr. 1018, 1021 (Bankr. M.D. Tenn. 1984); *see* Torres v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573, 1575 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986) (constructive trust is remedial and inchoate); McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1014 (Bankr. M.D. Tenn. 1983) (court creates constructive trust).

121. At least one court has taken a slightly different view of the question of timing, suggesting that if the constructive trust does not arise until the time of the decree, it is invalid as a postpetition transfer. Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 791 (Bankr. S.D.N.Y. 1986); *see* 11 U.S.C. § 549 (Supp. IV 1986) (invalidating some postpetition transfers of the property of the estate). This approach also mistakes the nature of a constructive trust. The purpose of the Code's provision on postpetition transfers is to stop unsupervised dealing in the debtor's assets and to protect certain transferees. *See* 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶¶ 549.01-549.02 (discussing the history of the provision and the objective of protecting certain

C. *Comments on the Bankruptcy Cases*

The concept of equitable ownership and the tendency to reify the constructive trust remedy have misguided the treatment of constructive trusts in bankruptcy. The limits courts have imposed in response to the interests of creditors are technical and incomplete. The only general principle that appears regularly in the cases is the maxim that equality is equity in bankruptcy.[122] This is not an adequate standard by which to evaluate constructive trust claims, for several reasons. First, equality among claimants is not always the rule in bankruptcy.[123] Second, if equality is the guiding standard, it is difficult to see why bankruptcy courts enforce constructive trust claims in any cases.

The courts need a new and more comprehensive approach. To begin, they must understand and apply constructive trusts as remedies against unjust enrichment. A remedy responds to the circumstances before the court—in this case, a contest between the constructive trust claimant and general creditors. The important question is whether credi-

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parties who deal with the debtor postpetition). It has no application to a constructive trust, which is not a transfer of property but a remedy for the consequences of past events.

Several cases suggest an additional limitation, that a constructive trust claim cannot survive a preferential transfer of the property to which the claim applies. *See In re* Preston, 76 Bankr. 654, 659-60 (Bankr. C.D. Ill. 1987); Research-Planning, Inc. v. Segal (*In re* First Capital Mortgage Loan Corp.), 60 Bankr. 915, 920 (Bankr. D. Utah 1986). For example, the debtor in *In re Preston* was a construction contractor who had obtained payment from project owners by means of false mechanics' lien affidavits (fraud). The debtor deposited the money in a bank account, and the depository bank immediately set off the deposit in satisfaction of an unpaid loan. After the debtor filed his bankruptcy petition, the trustee recovered part of the setoff from the bank as a voidable preference. The fraud claimants (unpaid mechanics and a project owner) asserted a constructive trust claim against the funds recovered by the trustee. *In re* Preston, 76 Bankr. at 655.

The bankruptcy court denied the remedy, holding that the trustee's power to recover preferential transfers overcame the claimants' right to a constructive trust. Thus, if the debtor had kept the money, the claimants would be entitled to full restitution. But when the debtor paid out the money, the claimants' right was destroyed, although the trustee later recovered the payments as preferences. The court based its decision in part on the position of the bank (the transferee) as a bona fide purchaser and in part on a "policy of creditor equality" expressed in the Code's preference provisions. *Id.* at 656-60.

In this case, the court's result seems correct as a matter of bankruptcy policy. The claimants lost their right to specific restitution when the debtor paid the money to the bank, a transferee for value without notice of the fraud claim. They would have had no further claim if the trustee had not recovered the money pursuant to the Code's preference provisions. The statutory authority of a bankruptcy trustee to recover preferential transfers serves a special purpose related to the effectiveness of bankruptcy as a collective creditors' remedy. *See* T. JACKSON, *supra* note 75, at 123-31. The power to recover preferences exists for the benefit of the collective estate, and the policies that support this power do not extend to enhancement of a particular claimant's position. Thus, if the funds are available to the estate only by means of the Code's preference provisions, they should not be subject to a constructive trust claim, to the exclusion of other creditors.

122. *See, e.g.*, D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 40 (Bankr. D. Kan. 1986); Neochem Corp. v. Behring Int'l, Inc. (*In re* Behring Int'l, Inc.), 61 Bankr. 896, 902 (Bankr. N.D. Tex. 1986).

123. Apart from the statutory priorities established by the Bankruptcy Code, *see* 11 U.S.C. § 507 (1982 & Supp. IV 1986), security interests and claims of ownership based on nonbankruptcy law create priorities among creditors. *See supra* note 75 and accompanying text. The Bankruptcy Code also provides for subordination of certain claims. *See* 11 U.S.C. § 510(b)-(c) (1982 & Supp. IV 1986) (subordination of claims based on rescission of securities transactions and equitable subordination).

tors will be unjustly enriched at the claimant's expense if allowed to share in the property she claims.

A few courts have been sensitive to the remedial function of constructive trusts and have considered the justice of the remedy as between the parties it affects. The best illustration is *Torres v. Eastlick (In re North American Coin & Currency, Ltd.)*.[124] This case involved a claim by customers of a dealer in precious metals (the debtor) for restitution of prepayments for orders the debtor never filled. The claimants alleged that the debtor had obtained their money by fraud, because the debtor's principals accepted their orders knowing the debtor was insolvent and near collapse. The claimants traced their deposits to a segregated bank account, but the court refused to impose a constructive trust on funds in the account.[125]

The court in *North American Coin & Currency* began by stating that state law is the initial source of the right to a constructive trust. But in the court's view, a claimant who would be entitled to a constructive trust in an action against the debtor under state law was not necessarily entitled to a constructive trust in bankruptcy. The court said, "A constructive trust is not the same kind of interest in property as a joint tenancy or a remainder. It is a remedy, flexibly fashioned in equity to provide relief where a balancing of interests in the context of a particular case seems to call for it."[126] On the facts of the case, there was no affirmative fraud, and the court declined to use its "more general equitable power" to elevate the plaintiffs above other creditors.[127] In other words, other creditors would not be unjustly enriched if allowed to share in the fund.[128]

The opinion in *North American Coin & Currency* is a move in the right direction. By focusing on the relative positions of the constructive trust claimant and other creditors, the court recognized the remedial nature of the constructive trust and brought the remedy closer to its substantive objective of preventing unjust enrichment.[129] But the court's

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124. 767 F.2d 1573 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986).

125. *Id.* at 1574-75.

126. *Id.* at 1575.

127. *Id.* at 1575-78.

128. Similar analyses appear in Elliott v. Frontier Properties/LP (*In re* Lewis W. Shurtleff, Inc.), 778 F.2d 1416, 1419-20 (9th Cir. 1985) (quoting *North American Coin & Currency*); Chbat v. Tleel (*In re* Tleel), 79 Bankr. 883, 886 (Bankr. 9th Cir. 1987) (quoting *North American Coin & Currency*); and Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 792 (Bankr. E.D.N.Y. 1986).

129. Another instance of a remedial approach to constructive trusts in bankruptcy is McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995 (M.D. Tenn. 1983). This case is interesting because the court imposed a constructive trust to correct an unjust enrichment arising in bankruptcy although the claimants might not have been entitled to restitution from the debtor under state law. The claimants had purchased land from the debtor some time before bankruptcy. In each case, the claimant obtained and recorded a deed, but the acknowledgment clause in the deed was technically defective. Under state law, a deed with a defective acknowledgement was invalid as against purchasers and creditors. Therefore, the strong arm provisions of the Bankruptcy Code allowed the trustee, as hypothetical lien creditor, to avoid the conveyances and claim the land. *Id.* at 1000-08. There

analysis is incomplete, because it does not explain why the creditors prevailed or when, if ever, unsecured creditors might be unjustly enriched by sharing in property subject to a constructive trust claim. The next section of this article offers tentative answers to these questions, which lead in turn to some limits on use of constructive trusts in bankruptcy.

IV. JUSTIFICATIONS FOR A CONSTRUCTIVE TRUST REMEDY IN BANKRUPTCY

The first step in defining a role for constructive trusts in bankruptcy is to identify the reasons for the constructive trust remedy. The object of this section is not to decide when an acquisition of benefits is an unjust enrichment between parties to a transaction; that is left to the substantive law of restitution. Instead, the purpose is to determine when restitution of specific property or its products, to the exclusion of general creditors, is necessary to prevent unjust enrichment. In other words, why is the constructive trust claimant placed ahead of a claimant who was severely injured by the defendant's negligent or willful acts, or a claimant who sold goods to the defendant and has not been paid?

There are many substantive grounds for constructive trust claims, and the justifications for priority are stronger in some cases than in others. The following discussion assumes the simplest type of claim, based on the debtor's wrongful acquisition of property from the claimant, and it also assumes the claimant has identified the misappropriated property or its products in the hands of the debtor. Later sections will apply the analysis developed here to claims of other types.

A. The Equation of Gain and Loss

The special feature of restitutionary claims is that they arise (in most cases) from the enrichment of one person at the expense of another.[130]

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would be no cause for a constructive trust outside bankruptcy, because the claimants owned the land and could perfect their rights by a reformation of the acknowledgements. *See id.* at 1009. Nevertheless, the court held the claimants were entitled to a constructive trust on the land, because *creditors* were unjustly enriched by the trustee's avoidance of the conveyances on the basis of technical defects. The debtor had no just claim to the land, and creditors could not have relied on the debtor's title because the conveyances were apparent from the record. *Id.* at 1013-14.

In granting the constructive trust remedy, the court did not follow the usual reasoning that the claimants had a preexisting equitable interest that excluded the land from the bankruptcy estate. In fact, it concluded in the first part of its opinion that any interest of the claimants, legal or equitable, was avoidable under § 544. It imposed the constructive trust in its capacity as an equity court, to prevent enrichment of creditors through the harsh application of the Bankruptcy Code on the facts of the case.

The court may not have been accurate in calling *Anderson* a constructive trust case; it could be equally described as an equitable exception to § 544. But the court did rely on the principle of unjust enrichment, and the case is interesting for its discussion of constructive trusts in remedial terms. *See also* Thunderbird Motor Freight Lines, Inc. v. Penn-Dixie Steel Corp. (*In re* Penn-Dixie Steel Corp.), 6 Bankr. 817, 824 (Bankr. S.D.N.Y. 1980), *aff'd*, 10 Bankr. 878 (S.D.N.Y. 1981) (dicta suggesting that the bankruptcy court as a court of equity could impose a constructive trust in a proper case).

130. J. DAWSON, *supra* note 2, at 5-7; Dawson, *supra* note 11, at 176-78; Fuller & Perdue, *The*

Compensatory claims allocate loss: for a variety of reasons, the law shifts the burden of the plaintiff's loss to the defendant. In most restitution cases—for example, when the defendant acquires property from the plaintiff by theft or fraud—there is both a loss to the plaintiff and a corresponding gain to the defendant. This correlation of gain and loss gives the restitutionary claim strong appeal in terms of fairness and corrective justice.[131]

Professor Dawson has described at length the favored treatment that our legal system and others have accorded to restitutionary claims in response to this equation of gain and loss.[132] Applying "some rudimentary psychology," he said that "loss alone is a grievance. But if this loss can be located and identified in the gain received by another, the anguish caused by the loss will be felt as more than doubled."[133] Professor Fuller expressed a similar idea when he ranked restitution highest in importance among the objects of contract damages:

> If, following Aristotle, we regard the purpose of justice as the maintenance of an equilibrium of goods among members of society, the restitution interest presents twice as strong a claim to judicial intervention as the reliance interest, since if A not only causes B to lose one unit but appropriates that unit to himself, the resulting discrepancy between A and B is not one unit but two.[134]

The restitutionary equation of gain and loss, however, does not always lead to a constructive trust. When a restitution claimant cannot trace her claim to specific property, her remedy is a money judgment in the amount of the defendant's unjust enrichment.[135] Such a claimant has no rights in specific property of the defendant and no priority over general creditors, despite the fact that the defendant was enriched at the claimant's expense.

Moreover, constructive trusts normally are not imposed to protect restitution interests arising from contract.[136] If the plaintiff has performed the contract and the defendant has not, there is an interrelated

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Reliance Interest in Contract Damages: I, 46 YALE L.J. 52, 56 (1936). Typically the defendant's gain corresponds to a loss suffered by the plaintiff, but this is not always true. *See* RESTATEMENT OF RESTITUTION § 160 comments a, d & e (1937); RESTATEMENT (SECOND) OF RESTITUTION § 32 comment b (Tent Draft No. 2, 1984); 1 G. PALMER, *supra* note 2, §§ 2.10-2.11; *supra* notes 11-14 and accompanying text.

131. J. DAWSON, *supra* note 2, at 5-7; Fuller & Perdue, *supra* note 130, at 56. For differing conceptions of corrective justice, see Coleman, *Corrective Justice and Wrongful Gain*, 11 J. LEGAL STUD. 421 (1982); Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151, 160-89 (1973) (correction based on causation); Fletcher, *Fairness and Utility in Tort Theory*, 85 HARV. L. REV. 537, 540-42 (1972) (correction based on nonreciprocity); Posner, *The Concept of Corrective Justice in Recent Theories of Tort Law*, 10 J. LEGAL STUD. 187 (1981) (reconciling justice and economics).

132. J. DAWSON, *supra* note 2, at 1-8; Dawson, *supra* note 11, at 177.

133. J. DAWSON, *supra* note 2, at 5.

134. Fuller & Perdue, *supra* note 130, at 56; *cf.* ARISTOTLE, NICOMACHEAN ETHICS § 5.5 (T. Irwin trans. 1985) (justice in rectification of gain and loss).

135. *See supra* notes 43-51 and accompanying text.

136. RESTATEMENT (SECOND) OF CONTRACTS §§ 344(c), 373 (1981); 1 G. PALMER, *supra* note 2, § 4.1; Fuller & Perdue, *supra* note 130, at 53-54.

loss and gain between the parties. Specific restitution is sometimes available as a remedy for breach of contract,[137] but courts generally have not allowed the contract plaintiff to trace and claim products of her performance by means of a constructive trust.[138] In any event, courts should not apply the constructive trust remedy to give a contract claimant priority in bankruptcy, because the contract claimant voluntarily assumed the position of a creditor, and took the risk of the defendant's subsequent bankruptcy.[139]

Thus, the correspondence of defendant's gain and plaintiff's loss does not provide a full explanation for constructive trusts and their incident of priority over general creditors. The equation of gain and loss is the foundation of a constructive trust claim, but something more is needed to understand and justify the constructive trust claimant's priority.

B. Unjust Enrichment Represented by Property

Prevailing constructive trust rules hold that the claimant must establish a connection between her claim of unjust enrichment and specific property in the hands of the defendant at the time of suit.[140] She must identify an asset that respresents the unjust enrichment, either in its initial form or as the visibly traceable product of an exchange. Otherwise, the claimant is in the position of a general creditor. Apparently, most courts view this transactional connection between the claim and specific property as a necessary part of the justification for the constructive trust remedy and its incident of priority. Yet, they do not explain how the connection to specific property adds to the strength of the claim and

137. *Compare* 1 G. PALMER, *supra* note 2, § 4.7(a) (describing a limited right to specific restitution) *with* RESTATEMENT (SECOND) OF CONTRACTS § 372 (1981) (proposing a more general right to specific restitution).

138. 1 G. PALMER, *supra* note 2, § 4.10(a), at 453; Dawson, *supra* note 11, at 182. Professor Palmer discusses several contract cases in which constructive trusts were used as a remedy for breach, but he cautions that the remedy should not apply in favor of a contract creditor at the expense of other creditors. 1 G. PALMER, *supra* note 2, § 4.10(a). He also describes land sale cases in which vendees were allowed to claim the vendors' profits from breach and resale, and suggests the same remedy should be available between the original parties in sale-of-goods cases. *Id.* § 4.9(a), (b); *see also id.* § 4.17(b) (equitable lien to secure restitution of price as a remedy for title defects in a land sale).

139. *See* 1 G. PALMER, *supra* note 2, § 4.10(a), at 453; Dawson, *supra* note 11, at 182-83. The Bankruptcy Code allows a seller of goods a very limited right to reclaim goods delivered to the debtor. When state law grants a right of reclamation against an insolvent buyer, *see, e.g.*, U.C.C. § 2-702 (1977), that right is effective in bankruptcy, but only if the seller exercises it by written demand within 10 days after the debtor's receipt of the goods, 11 U.S.C. § 546(c) (Supp. IV 1986). The negative implication of § 546 is that contract claimants have no further rights to specific restitution in bankruptcy.

Section 2-402 of the Uniform Commercial Code gives a buyer of goods a right to specific performance, in priority to unsecured creditors, if the goods are identified to the contract. U.C.C. § 2-402 (1977). For the reasons stated in the text, § 2-402 should not be effective in bankruptcy. *Cf.* T. JACKSON, *supra* note 75, at 65-67 (specific performance is not a state law property right). *But see* Proyectos Elecs., S.A. v. Alper, 37 Bankr. 931 (E.D. Pa. 1983).

140. *See supra* notes 43-51 and accompanying text.

why, among competing claimants, the one who can point to specific property as the subject of a restitutionary claim should have a better claim to that property than other creditors.

1. Gain Manifested in Assets

The main reason why a connection to specific property advances the case for priority over general creditors is that this connection makes it possible to say that the constructive trust will prevent unjust enrichment of creditors. Tracing the claim to particular assets demonstrates that the unjust enrichment is still present among the assets to be divided among competing parties. The constructive trust remedy avoids unjust enrichment of other creditors by denying them a share of property that would not be available for distribution but for the debtor's unjust gain at the constructive trust claimant's expense.[141]

This reasoning is partially undercut by the fact that accepted rules for tracing property and products do not necessarily establish that the unjust enrichment has increased the value of the pool of assets available to creditors. Professor Oesterle has demonstrated that a transactional connection between unjust enrichment and particular assets (typically an exchange of the original property for proceeds or products) is not equivalent to a causal contribution to the wrongdoer's wealth.[142] For example, assume a wrongdoer steals the claimant's money and uses it to buy stock he would otherwise have purchased with money of his own. Then he spends his own money on a vacation. The claimant can trace and claim the stock under prevailing tracing rules, but there is no net improvement of the wrongdoer's financial position.[143] On the other hand, the wrongdoer may use the claimant's money to pay expenses he otherwise would pay with his own money; or he may use it, while solvent, to discharge a debt. In those circumstances, the claimant's money has augmented the wrongdoer's net worth, but the claimant is not entitled to a constructive trust because he cannot trace to specific products of the original property.[144]

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141. Professor Dobbs makes this point in support of allowing a constructive trust claimant priority over other creditors with respect to restitution of products that exceed the value of the property lost, at least when the appreciation is moderate. D. DOBBS, *supra* note 8, § 4.3, at 244-45. Under the analysis proposed in this article, the claimant's priority would not extend beyond the amount of her loss. *See infra* notes 212-17 and accompanying text.

142. Oesterle, *supra* note 24, at 195-208.

143. *See id.* at 198-99 (using a similar illustration in reference to constructive trusts on appreciated property). Professor Oesterle gives other examples to illustrate inconsistent treatment of claimants under transactional tracing conventions and problems of apportioning profit. *Id.* at 200-08.

144. *See* 5 A. SCOTT, *supra* note 6, § 521, at 3648-49; Taft, *supra* note 50, at 189. If the wrongdoer uses the claimant's money to discharge an unsecured debt he would not otherwise pay with money of his own, the causal impact of the unjust enrichment on the assets available to creditors becomes complicated. In such a case, the claimant's contribution to the pool of assets available to creditors depends on the dividend the paid creditor would receive in bankruptcy and on the likelihood the paid creditor would have enforced her claim before bankruptcy (and before the preference period). *Cf.* Taft, *supra* note 50, at 178, 187-89 (apparently assuming other creditors are not harmed if the wrongdoer was solvent when he discharged the debt). If the wrongdoer used the money to

It might be possible to design a more accurate measure of the claimant's contribution to the wrongdoer's bankruptcy estate by abandoning transactional tracing rules in favor of a causal determination of enrichment. Rather than identifying specific property that represents the unjust gain, the claimant would have to show that the debtor actually was enriched, and that he still retained the value of the enrichment at the time of trial.[145] But a causal analysis could be costly and difficult to apply.[146] Determination of actual net enrichment would involve subjective speculation (would the debtor have paid a certain debt in any event?) and problems in allocating the burden of proof (must the claimant track all disbursements of the debtor's assets?).[147] Such an approach also would be a radical departure from prevalent state law governing constructive trusts.

Present tracing rules are easier to apply because they are objective and mechanical. Although a transactional method of tracing may not be a precise measure of the debtor's actual enrichment, it is at least a rough measure of the value added to the debtor's estate at the claimant's expense. Identification of specific products of the unjust gain suggests that the assets available to creditors have increased at the claimant's expense, and therefore adds to the relative strength of the claim.

2. *Property Reasons*

Another question is whether a constructive trust claim, traced to specific property, should have attributes of a property right. The term "property" is used here to mean rights and powers, relating to things, that are entitled to legal protection for reasons independent of unjust enrichment.[148] The primary function of a constructive trust is not to vindicate a property right in this sense, but to prevent unjust enrichment at

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discharge a secured debt, the constructive trust claimant will have recourse to the collateral through subrogation. *See supra* note 21.

145. This would be a form of the swelled asset theory, described *supra* note 50 and accompanying text. *Compare* Taft, *supra* note 50 (favoring the imposition of an equitable lien on general assets if the wrongdoer was solvent at the time of the unjust enrichment) *with* 5 A. SCOTT, *supra* note 6, § 521, at 3647-49 (rejecting all versions of the swelled asset theory). The approach described in the text would require proof of what Professor Scott called an "ultimate augmentation" of the estate. 5 A. SCOTT, *supra* note 6, § 521, at 3648-49. The claimant's equities in relation to other creditors come from the fact that creditors will share in the gain the wrongdoer obtained at the constructive trust claimant's expense. In that respect, an original augmentation of assets or proof that the wrongdoer was solvent at the time of the wrong is not relevant.

146. Professor Scott felt proof would be "impossible." 5 A. SCOTT, *supra* note 6, § 521, at 3649.

147. *Cf.* Taft, *supra* note 50, at 187 (allocating responsibilities of proof under a broader form of the swelled asset theory). To the extent that any burden of proof or production rests with the bankruptcy trustee, the cost of establishing the facts will fall on creditors. *Cf.* Bistate Oil Co. v. Heston Oil Co. (*In re* Heston Oil Co.), 63 Bankr. 711, 716 (Bankr. N.D. Okla. 1986) (refusing to allow a constructive trust claimant to trace into a commingled fund and shift the burden of proving contributions to the fund to the trustee, because the litigation would be a "waste of time and a waste of estate funds").

148. Property is an elusive term; any right in property depends on and is inseparable from the legal remedies available to enforce it. *See* J. BENTHAM, THE THEORY OF LEGISLATION 111-13 (R. Hildreth trans. C. Ogden ed. 1931).

the claimant's expense by placing her in the position of an owner. Earlier sections of this article suggest that constructive trusts should not be equated with ownership of property,[149] because the reference to ownership leads courts to apply the remedy formally and overlook the underlying questions of unjust enrichment. Nevertheless, the claimant has identified a certain thing that should belong to him. Therefore, it may be useful to consider the relationship of constructive trust claims to several theories of property law, to determine if and when the claimant should have the status of an owner in a contest with creditors.[150]

a. Utility

Legal rights to property are sometimes justified on grounds of utility or wealth maximization. People will not use and improve resources unless law and legal remedies assure them of of proprietary rights. Therefore, legal protection of claims to property is necessary to promote effective use of resources by individuals, to the greater benefit of society.[151]

In a few situations, the right to trace proceeds of misappropriation and obtain specific restitution may promote a desirable disposition of resources.[152] But in most cases, the constructive trust remedy is remote from the utilitarian function of property law. The willingness of an owner to spend time and money developing property will not be affected seriously by the risk that someone may misappropriate and exchange the property, or obtain title by fraud or mistake, and then file a bankruptcy petition before the owner can assert her rights. In any event, the incentive effect of a constructive trust remedy will be minimal, because the right to specific restitution is lost if the defendant dissipates the enrichment. In most cases, therefore, the validity of a constructive trust must depend on the principle of corrective justice, rather than the utility of a right to restitution of property.[153]

149. *See supra* notes 59-73 and accompanying text.

150. The following paragraphs are not intended as a comprehensive survey of theories about the meaning of property rights and their role in law. The object is to mention several property concepts that might support specific restitution by constructive trust and also to distinguish constructive trusts from rights of ownership. Theories of property are collected in J. CRIBBET & C. JOHNSON, CASES AND MATERIALS ON PROPERTY 3-54 (5th ed. 1984); J. DUKEMINIER & J. KRIER, PROPERTY 132-41 (1981); S. KURTZ & H. HOVENKAMP, CASES AND MATERIALS ON AMERICAN PROPERTY LAW §§ 1.2-1.8 (1987).

151. *See, e.g.*, J. BENTHAM, *supra* note 148, at 109-19; R. POSNER, *supra* note 131, § 3.1; Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347 (1967); Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1208-13 (1967); *cf.* Baker, *Property and Its Relation to Constitutionally Protected Liberty*, 134 U. PA. L. REV. 741, 748 (1986) (discussing "allocative" functions of property).

152. *See infra* notes 235-40 and accompanying text for an argument of utility in connection with constructive trust claims based on fiduciary misappropriation.

153. Other reasons for protecting entitlements by "property rules" (rules designed to prohibit involuntary transfer) or "liability rules" (rules that permit involuntary transfer, but require compensation) are suggested in Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1090-1108 (1972). The authors suggest that the

b. Personality

Another explanation for legal protection of property rights is that certain property is essential to the welfare or personal identity of human beings.[154] One interesting variation of this view of property rights is the theory of "property for personhood" developed by Professor Radin.[155] She explains that some forms of property, such as a home or an heirloom, become "bound up" with individuals' sense of themselves and their future.[156] This raises a strong moral claim to the property that the law should recognize and protect.[157]

In some situations, a concept of property for personhood would support the use of a constructive trust. If the defendant murdered his great aunt to inherit the family silver, a constructive trust claim by other relatives would have a compelling personal aspect.[158] A personhood theory of property would also help to explain the courts' attention to the physical identity of assets in constructive trust cases, because the function of self-definition is located in particular objects.[159]

Constructive trusts, however, extend far beyond what could be justified as property rights necessary to individual personality. Property for personhood does not encompass all assets a person might associate with herself, but only those that are closely tied to her identity. Further, this theory does not support the claimant's ability to trace products of the initial enrichment. If the defendant sold the silver and bought stock, the claimant cannot maintain that the stock is an essential part of herself from which she should not be separated. Thus, beyond a few narrow settings, neither utility nor personality requires that a restitution claimant who traces her claim to specific property should be treated as the owner of that property.

C. The Claimant as an Involuntary Creditor

Summarizing to this point, a constructive trust claim is supported

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choice between these types of rules should depend on the feasibility and cost of valuing the entitlement in a voluntary exchange, as well as other economic reasons and noneconomic distributional goals. Application of their economic analysis to the many bases of constructive trusts would be a large task and is not attempted here.

154. Several theories of property rights relating to individual liberty, welfare, self-definition, and security are summarized in Baker, *supra* note 151, at 744-48.

155. Radin, *Property and Personhood*, 34 STAN. L. REV. 957, 959-70 (1982). Professor Radin draws from the writings of Hegel. *See id.* at 971-78 (citing G. HEGEL, PHILOSOPHY OF RIGHT (T. Knox trans. 1821)).

156. *Id.* at 959-70.

157. *Id.* at 978, 986-88. Professor Radin indicates that entitlements to property tied to personhood should have priority over conflicting claims. *See id.* at 1014-15 ("personal" property rights should be protected against "cancellation" by claims of other people).

158. *See* RESTATEMENT OF RESTITUTION § 187 (1937); *cf.* Clark v. Kahn (*In re* Dlott), 43 Bankr. 789 (Bankr. D. Mass. 1983) (constructive trust claim to a one-half interest in the claimant's home, which the debtor retained as a result of a lawyer's error in drafting a deed).

159. Professor Radin discusses the importance of particular objects to her concept of personhood in Radin, *supra* note 155, at 1003-04.

by the restitutionary equation of loss and gain and by a tracing exercise that tends to show that the assets available for creditors have been increased at the claimant's expense. Still, these two elements do not fully explain the constructive trust claimant's priority over general creditors, because they do not distinguish her claim from the restitutionary claims of contract creditors. When a contract creditor has rendered performance to the debtor without payment, there is a corresponding gain and loss, and the contract creditor may be able to trace the benefit of her performance to specific assets. But the contract creditor generally is not entitled to priority by means of a constructive trust.[160]

The final element in favor of the constructive trust claim, which separates it from ordinary contract claims, is that the claimant did not extend credit voluntarily to the debtor. At least in the simple case of conversion, the constructive trust claimant did not choose to deal with the debtor, and so did not voluntarily assume the risk of the debtor's insolvency.[161] Further, unlike contract creditors, the constructive trust claimant had no opportunity to demand compensation for the risk of insolvency in the form of price or interest, or protection by means of collateral.[162]

Under the present system of priorities in bankruptcy, the claimant's position as an involuntary creditor is not enough, in itself, to place her ahead of other creditors. Some writers, citing reasons of both fairness and efficiency, have proposed that tort creditors and others who did not bargain in a meaningful way for the risk of insolvency should have a special priority in bankruptcy.[163] Neither state nor federal collection

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160. *See supra* notes 136-39 and accompanying text.

161. This point is made in Taft, *supra* note 50, at 185, though the author places greater weight on the equities of the claimant as an involuntary creditor than does this article. Professor Palmer also indicates that the principal justification for a constructive trust claimant's priority over other creditors is that the claimant did not voluntarily assume the risk of the debtor's insolvency. 1 G. PALMER, *supra* note 2, § 2.14, at 185-86. He cites *In re* Kountze Bros., 79 F.2d 98, 102 (2d Cir.), *cert. denied*, 296 U.S. 640 (1935), in which the court used similar reasoning in support of favorable presumptions that allowed the claimant to trace to the balance of a commingled fund.

162. *See* T. JACKSON, *supra* note 75, at 13 (discussing voluntary creditors' response to insolvency risks). For discussions of the economics of voluntary credit and the relation of security interests to credit costs, see Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986). *But cf.* Note, *The Proper Discount Rate Under the Chapter 11 Cramdown Provision: Should Secured Creditors Retain Their State Law Entitlements?*, 72 VA. L. REV. 1499, 1506-09 (1986) (describing a view of bankruptcy as a common disaster in which losses should be spread equally among all creditors).

163. *See* Schrag & Ratner, *Caveat Emptor—Empty Coffer: The Bankruptcy Law Has Nothing to Offer*, 72 COLUM. L. REV. 1147 (1972); Note, *Tort Creditor Priority in the Secured System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045 (1984). The note just cited refers primarily to personal injury claims, especially those based on products liability. The author proposes that tort claimants should have priority over both unsecured and secured creditors. Note, *supra*, at 1080-83, 1084-85. In support of the tort claimant's superpriority, the author cites reasons of fairness (emphasizing that the tort creditor has not extended credit voluntarily), a "norm of corrective justice," and the policies of compensation and risk spreading that underlie tort law. The author also constructs an economic model, arguing that the present ranking of claims prevents internalization of costs, reduces

law, however, has made a general distinction in favor of involuntary creditors.[164] A tort claimant who has suffered a loss but has no restitutionary claim to assets of the debtor is treated as a general creditor, even though she did not consent to be hit by the debtor's car.

Nevertheless, the involuntary nature of a constructive trust claim is a circumstance to be considered in combination with the others identifed above.[165] Unlike a contract creditor, the claimant did not agree to a risk of loss; and unlike an ordinary tort creditor, her loss corresponds to a gain she can locate among the debtor's assets. These elements together are the basis of the constructive trust claimant's priority over general creditors.

On the other hand, the characterization of a constructive trust claimant as an involuntary creditor does not hold true in all cases. When the basis of the claim shifts from theft to fraud or fiduciary misconduct or abuse of confidence, the distance between the constructive trust claimant and a voluntary contract creditor narrows. Later sections of this article explore the relative positions of the constructive trust claimant and other creditors in these cases.[166]

D. Deterrence[167]

Outside bankruptcy, one of the principal justifications for constructive trusts and tracing is their role in policing misconduct: the defendant

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the debtor's incentives to exercise care, and undermines efficient allocation of losses. *Id.* at 1057-70 (making an assumption that the potential for discharge in bankruptcy has incentive effects on the debtor's activities).

Professor Schrag and Mr. Ratner favor priority for consumer claims, particularly claims for reimbursement of prepayments for goods or services. They suggest that although consumers are voluntary creditors, a superpriority (or at least a generous application of the constructive trust remedy) is warranted "in view of the prepaying buyer's spectacular lack of reason to believe that he is risking his money." Schrag & Ratner, *supra*, at 1156-57, 1188. Congress has since addressed the position of consumers by enacting a limited priority for prepayment claims. 11 U.S.C. § 507(a)(6) (Supp. IV 1986); *see also* Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1405-19 (1986) (comparing classes of consensual and nonconsensual creditors and acknowledging some points in favor of priority for tort claimants); Warren, *supra* note 75, at 790 (citing the relative ability of claimants to bear costs of default as a factor in the distributional policies of bankruptcy law).

164. The priorities accorded in the Bankruptcy Code to consumer prepayment claims and employee wage claims may be based on concerns about these claimants' lack of ability to bargain for protection against the risk of bankruptcy and the absence of meaningful consent to extend credit. *See* Warren, *supra* note 75, at 790; *cf.* Buckley, *supra* note 163, at 1407-08 (taking a hard line).

165. *See supra* notes 130-47 and accompanying text.

166. *See infra* notes 221-48 and accompanying text.

167. In this and other sections of the text, the term "deterrence" is used to describe aspects of the constructive trust remedy that are based on the wrongful character of a defendant's acts and serve to deny him the fruits of his wrong. In fact, the courts may have at least two motives in applying rules of this kind. One is deterrence, meaning the imposition of a legal sanction against the defendant to discourage or remove incentives for like behavior. The other is retribution. *See* G. FLETCHER, RETHINKING CRIMINAL LAW § 6.3.2 (1978) (discussing criminal sanctions). For discussion of the role of these two purposes in punitive damage remedies, see Ausness, *Retribution and Deterrence: The Role of Punitive Damages in Products Liability Litigation*, 74 KY. L.J. 1, 39-67, 71-92 (1985-86); Ellis, *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1, 4-10 (1982); Schwartz, *Deterrence and Punishment in the Common Law of Punitive Damages: A Comment*, 56 S. CAL. L. REV. 133, 134-48 (1982).

must not be permitted to profit from a wrong.[168] A constructive trust serves this objective in several ways. Specific restitution ensures that the defendant will not benefit from noneconomic values or difficulties in damage measurement.[169] The tracing function of constructive trusts also has deterrent (or disincentive) effects. For example, if the defendant steals the claimant's money and uses it for a profitable investment in stock, the claimant is entitled to the stock. The result is a windfall for the claimant, but it is justified because it strips the defendant's wrongful activity (theft) of all benefits.[170]

Several subsidiary tracing rules reflect the same principle. When the defendant misappropriates the claimant's money, commingles it with his own, and makes withdrawals, the withdrawals are presumed to be made from the defendant's funds (unless they are well invested). Put another way, the claimant has an equitable lien on both the balance of the commingled fund and any products of the fund.[171] These rules do not describe the most probable path of the claimant's money, but they resolve doubts against the wrongdoer, and so prevent the possibility of profit from a wrong.[172] Similarly, when the wrongdoer has improved the original property or made a shrewd exchange, courts may not make allowance for the wrongdoer's contribution to the value of the property or its product.[173]

In some cases, deterrence principles alter the equation of gain and loss that is present in most restitutionary claims. For example, when a fiduciary obtains a benefit from a third party through a breach of duty

168. *See* RESTATEMENT OF RESTITUTION § 202 comment c (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 comment k (Tent. Draft No. 2, 1984); 1 G. PALMER, *supra* note 2, § 2.14(b), at 180; 5 A. SCOTT, *supra* note 6, § 508.1, at 3573; Ames, *supra* note 24, at 512; Williston, *supra* note 25, at 29; *cf.* Dawson, *supra* note 30, at 617-20 (distinguishing discouragement-of-the-wrongdoer's-profit motive from punishment).

169. *See* D. DOBBS, *supra* note 8, § 4.3, at 244-47.

170. RESTATEMENT OF RESTITUTION § 202 comment c (1937); RESTATEMENT (SECOND) OF RESTITUTION § 30 comment k (Tent. Draft No. 2, 1984). Professor Oesterle argues that deterrence is not an adequate justification for transactional tracing rules. He questions the propriety of imposing penalties by civil remedies, and points out that the extent of the penalty depends on fortuitous circumstances (subsequent disposition of assets) rather than the nature of the defendant's conduct. Further, tracing rules are not an effective deterrent because they invite a knowledgeable wrongdoer "to obscure the transactional trail." Oesterle, *supra* note 24, at 202-03.

171. Rules for tracing into commingled funds are described *supra* notes 52-58 and accompanying text.

172. *See* 1 G. PALMER, *supra* note 2, § 2.16(a), at 196. The equitable lien approach, which is adopted in the *Restatement*, eschews fictions about the wrongdoer's intent in disbursing funds, but replaces them with a different sort of fiction. Although the defendant has disbursed part of the money (which might be either the plaintiff's or the defendant's), the equitable lien preserves the plaintiff's claim to the full extent of the balance of the fund and traceable products of withdrawals. *See id.*

173. *See* RESTATEMENT OF RESTITUTION § 158 comment d (1937); D. DOBBS, *supra* note 8, § 4.5, at 274-77; 1 G. PALMER, *supra* note 2, § 2.12, at 161, § 2.13(b); Oesterle, *supra* note 24, at 195-98 & n.48, 200-02. Courts make a distinction when the wrongdoer applies misappropriated money to make improvements to property. In that case, the claimant is not entitled to the property or even to a proportionate interest in it; her remedy is limited to an equitable lien. RESTATEMENT OF RESTITUTION § 206 (1937); D. DOBBS, *supra* note 8, § 5.16, at 424.

(such as a trustee's commission on a sale of trust assets), the beneficiary is entitled to claim the benefit by a constructive trust. In such a case, the claimant has not suffered an economic loss; at most, the fiduciary's conflict of interest infringed the claimant's right to loyalty. But the claimant is entitled to the fiduciary's gain, primarily to deter the breach of duty.[174]

In bankruptcy, the deterrent reasons for constructive trusts and tracing disappear. Profit from wrongdoing is not an incentive unless the wrongdoer will realize the profit. When the contest for assets is between the restitution claimant and other creditors, a remedy that allocates property to one claimant in favor of others has no deterrent effect on the wrongdoer (their debtor).[175]

It follows that any instance or incident of the constructive trust remedy based solely on deterrence should be eliminated in bankruptcy, no matter how egregious the debtor's conduct. Conversely, the innocence of the debtor in obtaining the gain should not weigh against the constructive trust claimant if sharing the gain would result in an unjust enrichment of creditors. Comments in the *Restatement of Restitution* state that in a case of conscious wrongdoing, a constructive trust claimant is entitled to priority over creditors because creditors should not profit from their debtor's wrong.[176] It is important to understand that the drafters' exclusion of creditors cannot be supported in terms of deterrence. It is defensible, if at all, on the ground that the creditors will be unjustly enriched if allowed to share in a gain obtained at the claimant's expense.

E. Summary

It is wrong to begin analysis of a constructive trust claim in bankruptcy, as bankruptcy courts often do, with the assumption that the claimant is entitled to priority as the equitable owner of the property she claims. The claimant does not own the property unless the court grants the remedy.[177] If the court places her ahead of general creditors, it must be because general creditors would be unjustly enriched by sharing in the property.

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174. *See* authorities cited *supra* notes 12-14. There are also some situations in which courts purport to grant restitution, but concern with reliance leads them to relax the gain side of the equation. *See* Farash v. Sykes Datatronics, Inc., 59 N.Y.2d 500, 452 N.E.2d 1245, 465 N.Y.S.2d 917 (1983); 1 G. PALMER, *supra* note 2, § 4.2; 2 *id.* § 6.3(a) ("bargained-for" benefit); Dawson, *supra* note 30, at 577-85, 592-600. In such a case, however, the plaintiff could not obtain a constructive trust because her claim is not connected to property in the hands of the defendant. The remedy would be a money judgment by means of quasi contract.

175. This point was made in one bankruptcy case: Bistate Oil Co. v. Heston Oil Co. (*In re* Heston Oil Co.), 63 Bankr. 711, 716 (Bankr. N.D. Okla. 1986). The court did not reject the constructive trust remedy entirely, but it refused to apply favorable tracing presumptions when the result would have no deterrent effect on the debtor. Several authors have expressed the same view. *See* Davis, *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1, 46 (rescission remedy for securities fraud); Finkelstein & Robbins, *supra* note 57, at 68-69 (tracing).

176. RESTATEMENT OF RESTITUTION § 202 comment e (1937).

177. *Cf.* Cohen, *Transcendental Nonsense and The Functional Approach*, 35 COLUM. L. REV. 809, 814-17 (1935) (discussing transcendental nonsense in property law).

In a contest between the constructive trust claimant and other creditors, the claim of unjust enrichment depends on three facts: (1) the debtor obtained an unjust gain at the claimant's expense; (2) the claimant can identify the gain among the assets claimed by creditors; and (3) the claimant did not voluntarily extend credit to the debtor. These three elements of a constructive trust claim provide the basis for priority in bankruptcy. Deterrence is an important reason for constructive trusts outside bankruptcy, but it must be set aside when the claimant is competing for the property with other creditors. Occasionally, utility and other property concepts may weigh in favor of specific restitution, but they do not support a general assumption that the law should treat a constructive trust claimant as the owner of property traceable to her claim.

Whenever courts impose constructive trusts in bankruptcy, they will increase the costs of unsecured credit and interfere with the compensatory policies that support other involuntary claims. Further, proper application of the constructive trust remedy in bankruptcy, with reference to unjust enrichment of creditors, could involve the bankruptcy estate in difficult and costly litigation. Perhaps the reasons in favor of a constructive trust do not justify this added expense in any case. The answer depends on how much weight one gives to the "rudimentary psychology" suggested by Professor Dawson: the intuition that a loss reflected in another's gain is doubly felt and should be corrected.[178]

The intent of the present discussion is not to prove conclusively that a constructive trust claim should have priority over the claims of other creditors. The point is that the reasons identified above in support of constructive trust claims are the only justifications for priority. Equitable ownership justifies nothing, because it means nothing. Deterrence may be a justification for tracing remedies between the claimant and the defendant but not between the claimant and other creditors.

V. Determining Unjust Enrichment in Bankruptcy

The previous section identified the aspects of a constructive trust claim that distinguish and support it in a contest between the claimant and other creditors: (1) the correspondence of claimant's loss and debtor's gain, (2) the presence of the gain among the debtor's assets, and (3) the position of the claimant as an involuntary creditor. This section will assume that these circumstances, in combination, are sufficient to justify the claimant's priority over general creditors. The objective here is to translate the points that favor a constructive trust claimant over other creditors into limits on the use and operation of the remedy in bankruptcy.

178. *See* J. Dawson, *supra* note 2, at 5.

A. An Illustration

The maxim of equal treatment among creditors in bankruptcy is accurate in the sense that most creditors who have claims against the debtor, but no property rights in assets of the estate, are grouped together as unsecured creditors and treated equally in the division of assets. On the other hand, claimants who have property rights under state law have priority over other creditors: an owner who leased or bailed property to the debtor is entitled to her property,[179] and claimants who hold security interests in property of the estate are entitled to the value of their liens.[180] The Bankruptcy Code makes further exceptions to the principle of equality by according priority to certain categories of claims, such as wage and tax claims.[181] The constructive trust remedy creates another exception by elevating some types of restitution claims to the position of property claims.

For example, assume the following parties have asserted claims in a bankruptcy proceeding:

(1) the owner of a car the debtor stole;
(2) a claimant whom the debtor injured by deliberate or negligent acts;
(3) a claimant who sold goods to the debtor or performed services, and has not been paid; and
(4) an employee of the debtor claiming unpaid wages.

Among these claimants, the first is entitled to recover his car without the aid of a constructive trust, because he is deemed to retain title to the car. He has a right of ownership under nonbankruptcy law that continues in effect, although his property is in the possession of a debtor in bankruptcy.[182]

Number two, the tort victim, is a general unsecured creditor. This means she is entitled to a pro rata share of whatever assets remain after full satisfaction of property claims, administrative expenses, and other claims entitled to priority under the Bankruptcy Code. The fact that the tort claimant did not voluntarily extend credit to the debtor does not alter her position in bankruptcy; she must share with other unsecured

179. *See* 4 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 541.08[2]. In the case of a lease, the trustee in bankruptcy can affirm the debtor's lease and retain possession of the property, but only to the extent of the debtor's interest under the lease. *See* 11 U.S.C. § 365 (1982 & Supp. IV 1986).

180. *See supra* note 75 and accompanying text. These parties are not important to the present analysis, because their claims normally do not conflict with those of constructive trust claimants. A creditor who obtained a consensual security interest in property subject to a constructive trust claim, without notice of the claim, would have the status of a bona fide purchaser and would prevail over the constructive trust claimant. *See* RESTATEMENT OF RESTITUTION §§ 172, 173(2) & comment 1 (1937); 5 A. SCOTT, *supra* note 6, §§ 474-475. A conflict could arise between a constructive trust claimant seeking restitution of specific property and a creditor holding an involuntary lien on all assets of the debtor. *See* Reliance Ins. Co. v. Brown, 40 Bankr. 214, 218 (W.D. Mo. 1984) (constructive trust claimant prevailed over tax lien).

181. 11 U.S.C. § 507(a) (1982 & Supp. IV 1986).

182. *See, e.g.*, RESTATEMENT OF RESTITUTION § 160 comment j (1937); D. DOBBS, *supra* note 8, § 4.7, at 281-83; 3 G. PALMER, *supra* note 2, § 16.5(a), at 480.

creditors.[183]

Number three, the contract creditor, also receives a pro rata share of assets remaining after payment of prior claims. The employee is entitled to priority to the extent of two thousand dollars in unpaid wages, but otherwise shares with the others.[184]

At this point, assume that six more claimants appear:

(5) the owner of a car the debtor stole and sold, who can show the debtor invested the proceeds of the sale in stock, and who claims restitution of the stock by constructive trust;[185]

(6) the beneficiary of a trust managed by the debtor as trustee, who can show the debtor misappropriated money from the trust and used it to purchase stock, and who claims restitution of the stock by constructive trust;[186]

(7) the beneficiary of a trust managed by the debtor as trustee, who can show the debtor earned a commission on a transaction in trust property, and who claims restitution of funds traceable to the commission by constructive trust;[187]

(8) a claimant who paid money to the debtor in the mistaken belief that she owed him a debt and claims restitution of funds traceable to her payment by constructive trust;[188]

(9) a claimant the debtor fraudulently induced to exchange valuable stock for worthless stock, who claims restitution of the valuable stock by constructive trust;[189] and

(10) the owner of a car the debtor stole and sold, who cannot identify proceeds of the sale among the debtor's assets.[190]

Claimants five through nine meet the prevailing requirements for imposition of a constructive trust against the debtor. If their constructive trust claims are recognized in bankruptcy, they will realize their

183. Tort claimants have no special priority in bankruptcy. *See* T. JACKSON, *supra* note 75, at 31-32 (justifying the position of tort claimants on grounds of nonbankruptcy entitlement and the scope of bankruptcy policy). For an interesting argument in favor of priority for tort victims, primarily on economic grounds, see Note, *supra* note 163.

184. *See* 11 U.S.C. § 507(a)(3) (1982 & Supp. IV 1986).

185. *See* RESTATEMENT OF RESTITUTION § 202 (1937); 1 G. PALMER, *supra* note 2, § 2.2(b); *cf. In re* Graham, 28 Bankr. 928 (Bankr. N.D. Iowa 1983) (appropriation of property in violation of settlement decree).

186. *See* U.S. Life Title Ins. Co. v. Lester (*In re* Fieldcrest Homes, Inc.), 18 Bankr. 678 (Bankr. N.D. Ill. 1982); RESTATEMENT OF RESTITUTION § 202 (1937); G. BOGERT & G. BOGERT, *supra* note 6, § 921; 1 G. PALMER, *supra* note 2, § 2.14, at 177.

187. *See* RESTATEMENT OF RESTITUTION § 197 (1937); 1 G. PALMER, *supra* note 2, §§ 2.11(a); 4 *id.* § 21.7(a).

188. *See* Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788 (Bankr. E.D.N.Y. 1986) (refusing to impose constructive trust in bankruptcy); RESTATEMENT OF RESTITUTION §§ 23, 163 (1937); 2 G. PALMER, *supra* note 2, § 11.5(c); *cf.* Elin v. Busche (*In re* Elin), 20 Bankr. 1012 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983) (error in deed).

189. *See* Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928 (Bankr. M.D. Fla. 1983); RESTATEMENT OF RESTITUTION § 167 (1937); 1 G. PALMER, *supra* note 2, § 3.4.

190. RESTATEMENT OF RESTITUTION § 167 (1937); *cf.* Cunningham v. Brown, 265 U.S. 1 (1924) (denying constructive trust).

claims in full through specific restitution. Therefore, their claims will be satisfied in full before any value is distributed to the tort and contract creditors. They also take priority over the employee's wage claim, because her priority under the Bankruptcy Code applies only to the remaining distributable assets of the estate. In contrast, the tenth claimant must share with the tort and contract creditors, because she cannot trace her claim to specific assets of the estate. The following sections suggest some limits on this treatment of constructive trust claimants in bankruptcy, based on the principles of unjust enrichment developed throughout this article.

B. The Interests at Stake

The first question a bankruptcy court must ask in response to a constructive trust claim is whose interests the remedy will affect. In most bankruptcy proceedings, the affected parties are general unsecured creditors of the debtor: tort creditors and those who have voluntarily extended credit on an unsecured basis. If the debtor's liabilities exceed his assets, general creditors must share the unencumbered assets of the estate, and specific restitution to a restitution claimant will reduce the amount of each general creditor's share. When there are very few assets or a large number of priority claims (such as claims for taxes, wages, and expenses of administration), specific restitution may also affect priority claims.[191] If so, the policies reflected in the priority provisions of the Bankruptcy Code also become part of the balance.[192] In either case, the constructive trust remedy serves no deterrent function, because the wrongdoer (the debtor) has no further stake in the assets at issue. The constructive trust claimant's priority can only be justified by the gain to the estate and the nature of the restitutionary claim.

In some cases, however, the deterrent reasons for a constructive trust may apply in bankruptcy. This is true of the rare case in which the assets of the estate suffice to pay all claims in full. Another example is a constructive trust claim against exempt property, such as a homestead. In the case of exempt property, the debtor would otherwise retain the property after bankruptcy. If the debtor obtained the property wrongfully, the constructive trust remedy serves its nonbankruptcy function of preventing the wrongdoer from realizing a profit and has no effect on

191. This appears to have happened in *In re* American Int'l Airways, Inc., 44 Bankr. 143, 145, 147 (Bankr. E.D. Pa. 1984).

192. Employee claims provide an example. Employees asserting claims for unpaid wages have contributed value to the debtor's estate. Further, their position as creditors may not be voluntary in a meaningful sense, because they cannot effectively anticipate and protect themselves against the employer's insolvency. *See* Warren, *supra* note 75, at 790 (suggesting that the priority given to employee wage claims is based on their relative inability to bear the costs of default). Thus, the employees' case for priority is not much different from that of a constructive trust claimant, and it is hard to say employees would be unjustly enriched by sharing in the property at issue. Therefore, even if the constructive trust claimant has established a case for priority over general creditors, the court should not place her ahead of the employees' priority, as defined in the Bankruptcy Code.

other creditors.[193]

A different type of contest occurs when there are numerous restitution claims against the estate, based on large scale fraud or misappropriation. One example is a case in which the debtor marketed a Ponzi scheme, and defrauded investors have asserted claims far in excess of available assets.[194] Usually, bankruptcy courts have denied specific restitution to any of the investors, by imposing strict tracing requirements that prohibit tracing into commingled funds.[195] This approach is not always effective, however, because the claimant sometimes can trace her investment to a segregated fund.[196]

The problem of multiple restitution claimants can be addressed in terms of unjust enrichment, without relying on strict tracing rules. In a simple case in which all claimants in the bankruptcy proceeding are victims of the same fraudulent scheme, the bankruptcy court should deny all constructive trust claims. Even if some of the parties involved have managed to trace their funds, their claims do not differ substantially from

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193. This is illustrated by *In re* Graham, 28 Bankr. 928 (Bankr. N.D. Iowa 1983). The property at issue was a homestead, and the court imposed a constructive trust in favor of the debtor's former wife.

194. *E.g.*, Cunningham v. Brown, 265 U.S. 1 (1924); Rosenberg v. Collins, 624 F.2d 659 (5th Cir. 1980); Merrell v. Dietz (*In re* Universal Clearing House Co.), 62 Bankr. 118 (D. Utah 1986); Lawless v. Anderson (*In re* Moore), 39 Bankr. 571 (Bankr. M.D. Fla. 1984). Some other examples in which an enterprise of the debtor generated numerous constructive trust claims are Torres v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986) (prepayments for investment in precious metal); Heyman v. Kemp (*In re* Teltronics, Ltd.), 649 F.2d 1236 (7th Cir. 1981) (consumer prepayments); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980) (consumer prepayments); Shirley Co. v. Darr (*In re* Tap, Inc.), 52 Bankr. 271 (Bankr. D. Mass. 1985) (payments to a payroll agent); Schifter v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508 (Bankr. S.D. Fla. 1983) (prepayments for investment in mortgages). The two consumer prepayment cases arose under the former Bankruptcy Act. The limited priority now granted in the Bankruptcy Code for consumer prepayments may preempt constructive trust claims of this type. *See* 11 U.S.C. § 507(a)(6) (Supp. IV 1986).

195. *E.g.*, Cunningham v. Brown, 265 U.S. 1, 11-13 (1924); Rosenberg v. Collins, 624 F.2d 659, 663 (5th Cir. 1980); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965-66 (5th Cir.), *cert. denied*, 449 U.S. 833 (1980); Schifter v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508, 511-15 (Bankr. S.D. Fla. 1983).

196. This was the case in Torres v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573 (9th Cir.), *modified in other respects*, 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986). Principals of the debtor knew the debtor's finances were precarious when they received the claimants' funds for investment and placed the new funds in a segregated account. The funds were still in the account when the debtor's bankruptcy proceeding commenced. *Id.* at 1574-75. Nevertheless, the court denied relief to the claimants. In an opinion that is more sensitive to questions of unjust enrichment than many, the court found no proof of fraud and declined to impose a constructive trust on more general grounds in the circumstances of the case. *Id.* at 1575-78.

Standard tracing rules outside bankruptcy permit a fraud claimant to trace funds into a commingled account and obtain an equitable lien to the extent of the lowest interim balance of the account. *See supra* notes 52-58 and accompanying text. As described earlier, the Supreme Court and several others have adopted a federal tracing rule that precludes tracing into commingled funds, at least in cases of multiple claimants. Cunningham v. Brown, 265 U.S. 1, 12-13 (1924); *see supra* notes 84-97 and accompanying text. This solution does not address the problem directly. Rather than asking whether there will be unjust enrichment among claimants in the bankruptcy case, it relies on an artificial conclusion that funds disappear when commingled.

those of the competing parties on whom the burden of the remedy will fall. In other words, when all competing claimants are victims of the same fraud, others will not be unjustly enriched by sharing in the property at issue.

The problem is harder when the claimants in bankruptcy include both general unsecured creditors and a group of fraud victims claiming restitution. Assuming the restitution claimants have a strong claim, as against the general creditors,[197] one solution would be to adopt a form of causal tracing or swelled asset theory, by which the court would impose a constructive trust in favor of the group of fraud claimants to the extent they could show their funds added to the pool of available assets. As discussed earlier, this solution has corresponding costs.[198] Under present tracing rules, unless all the fraud claimants can trace their claims, the odd claimant who is able to identify funds probably should be denied a constructive trust remedy and treated equally with other claimants.[199]

C. *Equation of Gain and Loss*

When a constructive trust claimant competes with other creditors, the combination of a loss to the plaintiff and a corresponding gain to the estate is essential to her case for priority.[200] As discussed earlier, this combination of loss and gain is not present in all restitutionary claims. There are cases in which the defendant obtained a gain at the expense of the plaintiff's legal rights but without causing the plaintiff an economic loss.[201] This is illustrated by the classic case of *Beatty v. Guggenheim Exploration Co.*[202] The Guggenheim company had employed Beatty as an agent to investigate particular mining properties. Beatty became aware of other properties the employer was likely to want and purchased them for his own account. The court imposed a constructive trust on these properties and required Beatty to turn over the properties to his

197. The comparative positions of a claimant seeking a constructive trust on the basis of investment fraud and other creditors who have extended credit to the debtor is discussed *infra* text accompanying notes 233-34.

198. The possibility of a causal approach to tracing is discussed *supra* notes 141-47 and accompanying text.

199. If all the fraud victims could trace into a commingled account, the court might impose an equitable lien on the balance and allow each claimant a share in proportion to her respective contribution to the fund. To conform the remedy to the object of correcting unjust enrichment of creditors, the court would have to take into account all contributions to the mingled fund, including funds contributed by the debtor. Because the constructive trust remedy disadvantages other creditors, there is no basis for presumptions that resolve evidentiary uncertainty in the constructive trust claimant's favor. *See infra* notes 218-20 and accompanying text. Therefore, a portion of the mingled fund, in proportion to the debtor's contributions, should be available to general creditors.

At a certain point, the potential cost to the estate of litigating the measure of relief may outweigh whatever benefits the constructive trust would achieve in terms of corrective justice. *Cf.* Bistate Oil Co. v. Heston Oil Co. (*In re* Heston Oil Co.), 63 Bankr. 711, 716 (Bankr. N.D. Okla. 1986) (objecting to costs).

200. *See supra* notes 130-39 and accompanying text.

201. *See supra* notes 12-14, 187 and accompanying text.

202. 225 N.Y. 380, 122 N.E. 378 (1919).

employer at cost. The remedy did not depend on proof that Beatty's purchase had affected the price the employer would have to pay for the properties.[203] As a fiduciary, Beatty was bound to act solely in the interests of his principal, and the court would not permit him to retain profits obtained through a breach of that duty.[204]

Outside bankruptcy, the result in *Beatty v. Guggenheim Exploration Co.* is justified to police the loyalty of agents, by removing the possibility of gain through a breach of duty.[205] But in bankruptcy, when the impact of a constructive trust falls on other creditors, the remedy has no disincentive or punitive effect on self-interested agents. If the principal suffered no financial harm, the only purpose served by awarding the properties to her, in preference to other creditors, is to vindicate her right to loyalty. That is not enough to establish a claim of unjust enrichment as against creditors who stand to lose money or go uncompensated for personal injuries.[206] In bankruptcy, the court should deny a constructive trust, even though the debtor's breach of duty is reflected in a gain to the estate.

The problem is more difficult when the constructive trust claimant may have suffered a loss but cannot quantify it. For example, the debtor may have profited from wrongful use of the claimant's confidential business information or trade secrets. Restitution of the debtor's profits is a convenient remedy, not only for reasons of unjust enrichment but also because damages to the claimant's business or reputation are hard to prove.[207] But when the constructive trust claimant is asserting a right to

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203. *Id.* at 386, 122 N.E. at 380. The court suggested that Beatty's activities may have diverted profits from his employer, but it also stated that a diversion of profits was not essential to the imposition of a constructive trust. *Id.* In the circumstances of the case, proof of lost profits would depend on whether the employer would have discovered and purchased the properties in question before their values rose. In any event, the employer did not suffer an out-of-pocket loss in the transaction. At most, the agent obtained value the employer might otherwise have realized.

204. *Id.*

205. *See* RESTATEMENT OF RESTITUTION § 197 comment c (1937) (discussing improper commissions); 1 G. PALMER, *supra* note 2, § 2.11, at 144-49; 5 A. SCOTT, *supra* note 6, § 502, at 3555 (discussing improper commissions).

206. Perhaps in a collective proceeding, when all claimants compete for limited assets, not even a money claim for restitution is justified without proof of an actual loss. For example, suppose the debtor operates a large cave as a tourist attraction. An adjoining landowner obtains a survey showing that a portion of the cave extends beneath her property. The adjoining owner could not have used the cave herself, because she does not own an entrance; but she asserts a claim to a portion of the debtor's gains (measured by a share of profits or by an estimate of rental value). Outside bankruptcy, the adjoining owner's claim might succeed. *See* Edwards v. Lee's Adm'r, 265 Ky. 418, 96 S.W.2d 1028 (1936). But even a money remedy depends on the principle of unjust enrichment. In bankruptcy, in the absence of any actual financial loss, or even the loss of a right she might have exploited, the landowner's claim of unjust enrichment is less appealing. On the other hand, denial of the money claim in bankruptcy would be a substantial intrusion by the bankruptcy court into state restitution law. *See infra* notes 256-57 and accompanying text.

207. *See* D. DOBBS, *supra* note 8, § 6.6, at 493-95 (a general discussion of remedial problems in cases of interference with protected information, trade secrets, and ideas); *id.* § 10.5, at 693-97 (a discussion of trade secrets and confidential information). Misuse of confidential information by fiduciaries is one of the grounds recognized in the *Restatement of Restitution* for relief by constructive trust. RESTATEMENT OF RESTITUTION § 200 (1937).

priority over other creditors, there is no compelling reason to resolve evidentiary doubts in the claimant's favor. If the claimant cannot demonstrate that the estate was enriched at her financial expense, she should not be entitled to a constructive trust in bankruptcy.[208]

Another situation in which the defendant's gain does not represent an out-of-pocket loss to the claimant is a three party case, in which the defendant obtained something from a third party that would or should have gone to the plaintiff.[209] For example, a testatrix's will leaves all of her property to her grandson. The testatrix changes her mind and instructs her lawyer to draft a new will giving everything to her granddaughters. Before the testatrix has executed the new will, her grandson learns of her plans and poisons her. Outside bankruptcy, the granddaughters are entitled to a constructive trust on the property the grandson received under the will, because his title to the property is an offense to basic notions of justice.[210]

If the grandson is insolvent and files a bankruptcy petition, the granddaughters' case is not as clear. On one side of the argument, the debtor's enrichment was at the claimants' expense in that the property probably would have been theirs. Further, the loss of their expectancy frustrates the wishes of the testatrix. On the other side, the claimants did not suffer a loss of present wealth, and their enjoyment of the property was contingent on outliving the testatrix and staying in her good graces. As for the testatrix, she is dead. Whether the claimants should be entitled to a constructive trust in bankruptcy depends on how much weight is given to rights of inheritance and to the owner's right to direct the disposition of her property at death. Accepting the judgment of present property law, the balance probably favors the claimants.[211] The debtor's gain was at their expense, and creditors would be unjustly enriched by participating in it.

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208. The claimant in this case should be allowed a money claim for restitution of profits the debtor obtained through the use of the claimant's business information or trade secrets. *Cf. supra* note 206. The probability of an unquantifiable economic harm is enough to support the use of a profit measure to determine the amount of the claimant's general unsecured claim against the estate.

209. For discussion and examples of situations in which one party may be entitled to restitution of benefits the defendant obtained from a third party as a result of a wrong or mistake, see RESTATEMENT OF RESTITUTION §§ 169, 183, 184 & comments a, d-i, §§ 185-186 (1937); 1 G. PALMER, *supra* note 2, §§ 21.1-21.6; 5 A. SCOTT, *supra* note 6, §§ 471-471.2, 486, 489.1-489.4, 492.6.

210. This example is taken, with alterations, from Riggs v. Palmer, 115 N.Y. 506, 22 N.E. 188 (1889); *see* RESTATEMENT OF RESTITUTION § 184 comment i & illustration 12, § 187 (1937); 1 G. PALMER, *supra* note 2, § 20.3, at 188-95, § 20.8; 5 A. SCOTT, *supra* note 6, §§ 489.4, 492.6. Most courts would not allow the murderous heir to keep property obtained in this manner at the expense of the intended beneficiaries, though a few have differed out of concern for the formal requirements and policies of will statutes. *See* 1 G. PALMER, *supra* note 2, § 20.8.

211. Essays on inheritance and testamentary disposition are collected in DEATH, TAXES AND FAMILY PROPERTY: ESSAYS AND AMERICAN ASSEMBLY REPORT 1-39 (E. Halbach ed. 1977); and *Inheritance of Property and the Power of Testamentary Disposition*, 1 SOCIAL MEANING OF LEGAL CONCEPTS 1 (1948).

D. Tracing Problems

Application of the constructive trust remedy in a contest among creditors also calls for adjustments in tracing rules. Proof that gains obtained at the constructive trust claimant's expense are among the assets of the debtor's estate is part of the claimant's case for priority.[212] Although the transactional link established by tracing products of exchange of the claimed property is not exact proof of the claimant's contribution to the available estate, its value as an estimate of the estate's gain is accepted for purposes of this discussion. On the other hand, particular tracing rules that are designed to facilitate the constructive trust claimant's recovery, rather than to identify as nearly as possible the actual products of the debtor's unjust gain, should not be applied at the expense of other creditors.

Several incidents of present tracing doctrine are essentially deterrent in nature, and should be eliminated in most bankruptcy cases. One example is the ability to trace and claim exchange products that exceed the value of the original property the debtor obtained at the expense of the constructive trust claimant. This aspect of tracing and its role in bankrupty are illustrated by the facts of *In re Graham*.[213] A settlement agreement between the debtor and his former wife required him to sell certain securities and life insurance, and apply the proceeds for the benefit of the wife by discharging joint debts. The debtor disregarded the agreement and used the money to make a down payment on a house. In a subsequent bankruptcy proceeding, the court held the wife was entitled to a lien on the house to secure her claim for the value of the securities and insurance.[214] Alternatively, she could claim a fractional interest in the house by means of a constructive trust.[215]

The court's alternative decision to allow the wife a constructive trust means that if the house had appreciated, the wife would obtain a property interest greater in value than the securities and insurance the debtor had appropriated at her expense. The decision was fair in the circumstances of the case, because the house was exempt from distribution to creditors under a state homestead exemption.[216] But if the house were not exempt property, a constructive trust giving the wife a fractional share of appreciated property would not be appropriate in bankruptcy. Appreciation in the value of property wrongfully obtained may be an

212. *See supra* notes 140-59 and accompanying text.

213. 28 Bankr. 928 (Bankr. N.D. Iowa 1983).

214. *Id.* at 930-31. The court apparently found that the settlement agreement and dissolution decree created an express lien on the insurance policies and securities and on the proceeds of either. Even if there were no express lien, the court might have imposed an equitable lien. *See* Simonds v. Simonds, 45 N.Y.2d 233, 380 N.E.2d 189, 408 N.Y.S.2d 359 (1978) (described *supra* note 46).

215. *In re* Graham, 28 Bankr. at 931-32.

216. *Id.* at 930. The Bankruptcy Code allows the debtor to elect between exemptions provided by state law and an alternative list of exemptions set out in the Code. 11 U.S.C. § 522(b), (d) (1982 & Supp. IV 1986). In *Graham*, state law was more favorable, and the debtor had claimed a state homestead exemption. *See* IOWA CODE ANN. §§ 561.1-561.3, 561.16 (West 1950 & Supp. 1989).

unjust enrichment of the wrongdoer because it is a gain derived from his wrongful act, but it does not unjustly enrich his creditors. In bankruptcy, the proper remedy is an equitable lien on the product (the house) in the amount of the initial unjust enrichment at the claimant's expense (the value of the securities and insurance).[217]

The difference between the reasons for a constructive trust against a wrongdoer and the reasons for a constructive trust against his creditors also affects the problem of tracing into commingled funds.[218] In a contest between the constructive trust claimant and other creditors, the court should avoid rules or presumptions that resolve doubts in the claimant's favor, because their justification is punitive. For example, a bankruptcy court should not presume the debtor spent his own money first, or allow the constructive trust claimant an equitable lien in the full amount of her claim on the balance of a commingled fund.[219]

This does not mean, however, that the debtor's commingling of funds automatically should defeat the claim to an equitable lien on part of the fund. Physical identification of money is not necessary to establish the equity of the claimant's case as against other creditors. When the debtor places misappropriated money in a commingled fund, the unjust gain does not disappear from the pool of his assets; it is represented in the fund. There is no justification in bankruptcy for a presumption that subsequent withdrawals were made first from the debtor's share of the fund, but there also is no reason to presume the claimant's money was the first disbursed. The best solution, as between the constructive trust claimant and creditors, is a proportional division. If the debtor obtained fifty dollars from the claimant and deposited it with fifty dollars of his own, and there are sixty dollars remaining at the commencement of bankruptcy, the constructive trust claimant should receive thirty dollars.[220] This so-

217. Professor Palmer takes this view. 1 G. PALMER, *supra* note 2, § 2.13(a), at 167, § 2.4(c), at 183-85. Professor Dobbs also suggests the claimant's remedy should be limited to an equitable lien, at least in some situations. D. DOBBS, *supra* note 8, § 4.3, at 244-46. In contrast, the *Restatement of Restitution* permits the claimant to elect a constructive trust, explaining that creditors should not profit from the debtor's wrong. RESTATEMENT OF RESTITUTION § 202 & comment e (1937); *see* 5 A. SCOTT, *supra* note 6, § 508, at 3573. The *Restatement* fails to recognize that to the extent the defendant's profits exceed the claimant's loss, preventing profit from the wrong is a deterrent concept that is logically inapplicable to creditors.

218. The operation and rationale of rules for tracing into and out of commingled funds are discussed *supra* notes 52-58 and accompanying text.

219. *See supra* notes 171-72, 175 and accompanying text.

220. To complicate the problem, assume the debtor withdrew $80 of the original $100, dissipated $40, and invested $40 in property that has since appreciated in value to $60. The balance remaining in the account is $20. The claimant, having contributed one-half of the original fund, should have a lien to the extent of one-half of the total of the remaining balance and the products, up to the amount of her loss. Specifically, she should recover $40. This allows the claimant to share in the appreciation of the products of the fund, but it does not result in a windfall, because the claimant's recovery does not exceed her loss. A further qualification may be necessary if the appreciation in the value of the product is attributable to the debtor's effort and skill. In that case, the increase should be shared among all creditors, and the claimant's lien should be limited to the original value of the traceable property. For example, if the debtor invested the $40 in property and then made repairs or improvements that increased its value to $60, the claimant should receive only $30 (one-

lution may be equally as artificial as allowing the claimant an equitable lien on the lowest intermediate balance of the fund, but it is not biased in the constructive trust claimant's favor. Therefore, it is preferable to prevailing nonbankruptcy rules in a contest between the constructive trust claimant and creditors.

E. The Claimant's Dealings with the Debtor

The final element in the justification of a constructive trust claimant's priority over general creditors is that the claimant did not extend credit voluntarily to the debtor.[221] This distinguishes her claim from that of a contract creditor who has added to the debtor's assets by performance of the contract. In doing so, the contract creditor voluntarily took the risk of the debtor's default and bankruptcy. She had a chance to bargain for compensation for the risk of loss, while the involuntary creditor did not.

Among the many grounds for imposition of a constructive trust, however, some may not fit the model of an involuntary extension of credit. If the debtor converted property of the claimant and the two are strangers, the claim is involuntary. In other cases, when the constructive trust claimant has dealt with the debtor and, to some extent, accepted the risk of misconduct by the debtor, the contrast between the constructive trust claimant and a voluntary contract creditor is not as sharp. If the claimant understood (or should have understood) that she might end up in the position of creditor, this circumstance decreases the relative appeal of her claim as against other creditors. The issue raised by a voluntary transaction between the constructive trust claimant and the debtor is not one of ostensible ownership; in a contest between the claimant and unsecured creditors, creditors' reliance on the property in question is not a substantial factor.[222] The important point is that if the claimant effectively took a credit risk in dealing with the debtor, other creditors will not be unjustly enriched by sharing in the property she claims.

1. Fraud and Related Wrongs

Courts frequently grant specific restitution as a remedy for fraud or related misconduct in otherwise voluntary transactions.[223] If the fraud is

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half of the money invested from the mingled fund and one-half of the money still in the account). *Cf.* 1 G. PALMER, *supra* note 2, § 2.12, at 161 (discussing problems of allocating profit or appreciation).

A more sophisticated analysis of the mathematics of commingled fund tracing appears in Finkelstein & Robbins, *supra* note 57.

221. *See supra* notes 160-66 and accompanying text.

222. The question of ostensible ownership is discussed *supra* note 111 and accompanying text. If creditors have relied on the debtor's apparent title to the assets at stake, the problem can be addressed specifically through the defenses of laches and estoppel, as discussed *infra* notes 249-54 and accompanying text.

223. On remedies for fraud, see generally D. DOBBS, *supra* note 8, ch. 9; W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS §§ 105-106 (5th

such that the claimant did not and could not fairly be expected to perceive the risk of loss, the claimant should be treated as an involuntary creditor. But in some cases, the circumstances of the fraud raise difficult questions of comparison between the constructive trust claimant and other creditors.

In *Central Trust Co. v. Shepard (In re Shepard)*,[224] for example, the debtor and the constructive trust claimant (a bank) had entered a "merchant servicing agreement," by which the bank agreed to give the debtor instant credit based on customer charge slips. The debtor collected charge slips in small amounts through its phone order business; then it altered the slips to larger amounts, deposited them with the bank, and withdrew cash far in excess of the actual value of the customers' obligations. The bank was fortunate enough to trace a packet of bills still in a wrapper and marked with the name of the bank, and the debtor's bankruptcy court imposed a constructive trust on the money.[225]

In this situation, the bank should not be placed ahead of other creditors. There was an unjust gain, obtained at the bank's expense and traceable among the assets of the estate, but the bank had agreed to place money in the hands of the debtor in circumstances vulnerable to the debtor's misconduct. The bank could have protected itself, and may in fact have protected itself, by adjusting the terms of the merchant servicing agreement to reflect the possibility of fraud. It may be that the debtor's act of forgery was more wrongful than a simple breach of contract, but the degree of the debtor's wrongdoing is not important in a contest between the bank and other creditors. In effect, the bank assumed credit risks, and there is little to distinguish its constructive trust claim from the claims of contract creditors who extended credit by agreement.

This is not to say that bankruptcy courts should deny all constructive trust claims based on fraud or misconduct in a voluntary transaction. There are many variations of fraud, and the constructive trust claimant's position in comparison to other creditors will depend on specific facts about his transaction with the debtor. To determine whether other creditors will be unjustly enriched by sharing in the property at issue, the court must consider the degree to which the claimant chose to deal with the debtor, understanding that she ran a risk of loss through the debtor's misconduct and insolvency.

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ed. 1984); 1 G. PALMER, *supra* note 2, §§ 3.1-3.4. Strictly defined, fraud means knowing misrepresentation intended to deceive another and induce her to act, on which the other relies to her detriment. At least some of the remedies available to a victim of fraud have been extended to cases of nondisclosure, innocent misrepresentation, and other variations from the traditional definition of fraud. Related wrongs that affect the integrity of voluntary transfers of title include duress, undue influence, and constructive fraud arising from nondisclosure or overreaching by the dominant party in a confidential relationship. *See generally* D. DOBBS, *supra* note 8, §§ 10.1-10.4; 2 G. PALMER, *supra* note 2, §§ 9.1-9.3; 4 *id.* §§ 19.1-19.2, 20.2(c).

224. 29 Bankr. 928 (Bankr. M.D. Fla. 1983).

225. *Id.* at 930-32.

The characterization of a fraud claimant as a voluntary or involuntary creditor depends in part on the commercial nature of the transaction and the commercial sophistication of the claimant. Outside bankruptcy, remedies for fraud in commercial settings promote integrity in business transactions.[226] Protecting the integrity of commerce, however, is a policing function that is achieved by remedies against the wrongdoer and, therefore, should not enter into the allocation of assets between the claimant and other creditors. As against general creditors, a constructive trust claim based on fraud in a nonbusiness setting, or fraud that occurred in a business transaction but was practiced against an unsophisticated victim, is more compelling because the claimant's transaction with the debtor is less like a deliberate and informed extension of credit.

The nature of the fraud is also important in determining whether the constructive trust claimant's position is essentially voluntary. One question is whether the particular fraud practiced on the claimant was a cognizable risk of the transaction, such as forgery in a deposit arrangement. Another is whether the fraud occured in the primary negotiations between the parties, so as to prevent an informed decision by the claimant to do business with the debtor. If the debtor misrepresents his identity or professional status, the fraud tends to vitiate the voluntary nature of the transaction. In comparison, the fraud practiced on the bank in *In re Shepard* was a foreseeable risk in the debtor's performance of a agreed to fairly transaction.

None of these points is a decisive test for all cases; the constructive trust claimant's position as a voluntary creditor is a question of degree. Assume, for example, that the debtor is a jewelry dealer. Prior to bankruptcy, the debtor appraised the claimant's ring, fraudulently informed her it was worth one hundred dollars, and bought it from the claimant at that price. In fact, the ring is worth one thousand dollars. In bankruptcy, the claimant seeks restitution of the ring by constructive trust. The claimant in this case agreed to deal with the debtor and in that sense, took a risk of fraud and subsequent bankruptcy. But she relied on the apparent expertise of a dealer in a business in which she had no experience. A person in this position cannot reasonably be expected to anticipate and protect herself against the dealer's fraud. In these circumstances, the claimant should not be viewed as a voluntary creditor who took a credit risk with respect to the true value of her ring.[227]

A somewhat harder problem is the case of an unenforceable oral promise to hold land in trust. For example: prior to bankruptcy, the

226. *See* W. KEETON, D. DOBBS, R. KEETON & D. OWEN, *supra* note 223, § 42, at 276. In rescission cases, there are also countervailing concerns about the reliability of commercial transactions. *See* 1 G. PALMER, *supra* note 2, § 3.1, at 229.

227. A similar situation is the case of the rolled-back odometer, in which a consumer pays a large price to a car dealer for a bad used car, based on a false representation of the car's mileage. *See* RESTATEMENT (SECOND) OF CONTRACTS § 159 comment a, illustration 1 (1981); RESTATEMENT (SECOND) OF TORTS § 525 comment b, illustration 1 (1977).

debtor induced his daughter to convey a piece of property to him, promising orally that he would manage the property for the daughter and reconvey the property on demand. The oral promise is unenforceable under the statute of frauds. The evidence shows that the debtor intended from the outset to ignore his promise and use the property for his own purposes. The daughter is inexperienced in legal matters, and there is no suggestion of collusion.[228] In the father's bankruptcy, his daughter seeks restitution of the land by constructive trust.

Again, the constructive trust claimant chose to deal with the debtor. Further, at least in objective terms, the risk of a loss in the event of bankruptcy was evident: the claimant entrusted the debtor with title and failed to retain a legally effective interest in the property. On the other hand, it is doubtful that she entered the transaction with a fair understanding of its risks. The fraudulent promise affected her initial decision to enter into the arrangement. She expected to have continuing rights in the property and probably did not perceive the arrangement as an extension of credit. Moreover, even if the daughter saw that she was parting with her property interest and relying on the debtor's credit, the personal context and the claimant's inexperience suggest she could not judge the risk of loss as a business creditor would. This is a close case, but the claimant's position is not fully voluntary, and she certainly was not compensated for credit risks. In bankruptcy, she probably should be allowed to reclaim her land, unless there are indications of collusion to defraud creditors or reliance by creditors on the debtor's title.[229]

On the other hand, there are limits on the extent to which a claimant's unworldliness should protect her in a contest with other creditors. For example, consider the facts of *Sharp v. Kosmalski*.[230] The constructive trust claimant, a fifty-six-year-old farmer with scant education, fell in love with the defendant, a school teacher sixteen years younger than the claimant. The defendant rejected the claimant's proposals of marriage but accepted a series of gifts, including a deed to his farm and most of his

228. This example is taken, with substantial alterations, from Gregory v. Bowlsby, 115 Iowa 327, 88 N.W. 822 (1902). In *Gregory v. Bowlsby*, a father persuaded his children (who apparently were adults) to execute a deed conveying to him their title to property they had inherited from their mother. The father promised orally to preserve the land and leave it to the children at his death. Later, he conveyed an interest in the land to his second wife, and the children brought suit against both the father and the second wife to reclaim their title. The statute of frauds prevented the children from establishing an express trust, but the court held they were entitled to a constructive trust if they could prove their father intended from the outset to breach his oral promise and dispose of the property as he wished. If so, his promise would be equivalent to a fraudulent misrepresentation and would support their claim for rescission and specific restitution. Creditors' interests were not at stake.

229. The discussion in the text assumes the transaction between father and daughter took place before the daughter encountered or anticipated financial difficulty. If the parties acted in collusion to mislead or delay the daughter's creditors, the constructive trust claim would be subject to the defenses of unclean hands and estoppel. *See* D. DOBBS, *supra* note 8, § 2.3, at 41-45, § 2.4, at 45-47; E. RE, *supra* note 61, at 523-35 (unclean hands). For a critical analysis of the doctrine of unclean hands, see Z. CHAFFEE, SOME PROBLEMS OF EQUITY 1-13, 15-22, 94-102 (1950).

230. 40 N.Y.2d 119, 351 N.E.2d 721, 386 N.Y.S.2d 72 (1976).

assets. Some time later, the relationship ended, and the defendant ordered the claimant off the farm with three hundred dollars in his pocket.

The court imposed a constructive trust on the farm, though the defendant had made no express promise to hold the land for the claimant's benefit and the evidence did not establish a case of undue influence. The court characterized the relationship of the parties as confidential and "instinct with an obligation."[231] In the court's view, the defendant breached the implicit understandings of the relationship, and should not be permitted to gain from the claimant's dependence and trust.[232]

No creditors were involved in *Sharp v. Kosmalski*; the contest for the farm was strictly between the claimant and the hardhearted school teacher. But assume the defendant was heavily in debt, and the claim arose in bankruptcy. The foundations for priority seem to be in place: the debtor obtained property at the claimant's expense; the gain is identifiable among the assets of the bankruptcy estate; and the claimant likely did not perceive and assess the transaction as a credit risk. Nevertheless, his claim to priority over general creditors is troubling. Part of the problem in this case is the weakness of the restitutionary claim: an enrichment occured, but it was only marginally unjust. There was no deception or factual misundertanding; the claimant's decision to give his property to the defendant was freely (if unwisely) made. He intended to make an absolute gift, and its consequences would be obvious to most people. The constructive trust remedy in *Sharp v. Kosmalski* was based on the court's sense that it was unfair for the defendant to take and keep the benefit of the claimant's foolishness in a personal situation. In bankruptcy, the claimant's poor judgment in placing his assets in the hands of the defendant without limitation simply is not enough to distinguish him from other creditors and establish that they will be unjustly enriched if allowed to share in the property.

Another situation in which the constructive trust claimant's transactions with the debtor may affect her claim to priority over other creditors is a debtor's fraudulent investment scheme. *Cunningham v. Brown*, the case of Ponzi, is an example.[233] The investors who sought constructive trusts on Ponzi's assets had loaned money to him in exchange for his promise to pay them 150% of their advances within ninety days from the profits of his postal coupon business. The promise was a fraud, because there was no postal coupon business.

One point in favor of the claimants in *Cunningham* is that the debtor's fraud affected their initial decision to deal with him. On the other hand, these claimants gave their money to the debtor in a business

231. *Id.* at 121-22, 351 N.E.2d at 723, 386 N.Y.S.2d at 74 (quoting Sinclair v. Purdy, 235 N.Y. 245, 254, 139 N.E. 255, 258 (1923)).

232. *Id.* at 122-24, 351 N.E.2d at 723-24, 386 N.Y.S.2d at 75-76.

233. 265 U.S. 1 (1924). The case is discussed *supra* notes 84-94 and accompanying text. The position of a constructive trust claimant in competition with other victims of the same wrongdoing is discussed *supra* notes 194-99 and accompanying text.

context, as an investment in an obviously speculative enterprise. They voluntarily took the risk of the debtor's solvency and the success of his business, if not the risk of its existence.[234] As against the debtor, they should be entitled to rescind the transaction and recover the money. But they should not be entitled to a constructive trust in bankruptcy, because their claims are not substantially different from those of ordinary contract creditors, who added value to the estate in the expectation of a return performance.

2. *Fiduciary Arrangements*

The beneficiary of a trust or other fiduciary relationship traditionally has been entitled to trace and claim products of property misappropriated by the fiduciary, to the exclusion of the fiduciary's other creditors.[235] In one noted case, the court explained the beneficiary's priority by saying that "the fiduciary's creditors have accepted the risk of his solvency, while his cestuis have accepted only the risk of his honesty."[236] In other words, the court viewed the claimant as an involuntary creditor, in comparison with other creditors. This characterization, however, is not completely satisfactory. Trusts, attorney-client relationships,

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234. *See* Official Cattle Contract Holders Comm. v. Commons (*In re* Tedlock Cattle Co.), 552 F.2d 1351, 1353-54 (9th Cir. 1977). This was not a constructive trust case. The dispute concerned the measure of damages to be used in allowing money claims by defrauded investors. On that point, the court approved the trustee's proposal for apportionment of assets among claimants according to their out-of-pocket loss (rather than their expectancy). Apparently, the interests of other creditors were not raised. The court added in dicta, however, that if claims of trade creditors were involved, it would consider subordinating the claims of the defrauded investors to those of trade creditors. It reasoned that the investors "planned to take some risks," while the trade creditors "were not planning to invest in the risk-taking phase of the business," and so, "became captive risktakers." *Id.* at 1353.

Since the *Tedlock* case, there have been changes in bankruptcy legislation that may affect the claims of defrauded investors. The current Bankruptcy Code provides for subordination of claims "arising from rescission of a purchase or sale of a security of the debtor." Rescission claims are postponed until all claims that would be senior to the claimant's securities have been paid. 11 U.S.C. § 510(b) (Supp. IV 1986). Thus, if an investment in a Ponzi scheme is considered a security of the debtor, restitutionary claims (which in effect are rescission claims) would be subordinated. *See* Securities & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293 (1946) (defining "security"). In several post-Code cases involving Ponzi schemes, this issue was not raised, possibly because the constructive trust claimants were not asserting claims against the estate but defending themselves against actions brought by the trustee to recover prepetition payments as preferences or fraudulent conveyances. *See* Merrell v. Dietz (*In re* Universal Clearing House Co.), 62 Bankr. 118 (D. Utah 1986); Lawless v. Anderson (*In re* Moore), 39 Bankr. 571 (Bankr. M.D. Fla. 1984).

The comparative positions of a claimant seeking to rescind a purchase of the debtor's securities and other creditors in bankruptcy are discussed in Davis, *supra* note 175 (suggesting that the rescission claim should be apportioned between business loss and loss specifically attributable to fraud, and that only the former component of the claim should be subordinated); Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973) (proposing a subordination rule similar to that adopted in the Bankruptcy Code on the ground that purchasers of securities assumed the risk of business failure).

235. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 202 (1959); 5 A. SCOTT, *supra* note 6, §§ 508, 508.1, at 3573-74.

236. *In re* Kountze Bros., 79 F.2d 98, 102 (2d Cir.), *cert. denied*, 296 U.S. 640 (1935), *discussed in* 1 G. PALMER, *supra* note 2, § 2.14(c), at 185-86.

and similar fiduciary arrangements are consensual transactions. The beneficiary (or a settlor from whom the beneficiary's rights derive) selects the fiduciary and places property in his control. Thus, in entering into the arrangement, the beneficiary takes the risk that the fiduciary not only will be dishonest but also will be insolvent when the beneficiary asserts a claim. In terms of voluntary assumption of credit risks, it is difficult to distinguish the beneficiary from a contract creditor.

In this situation, however, reasons of utility intervene to justify the constructive trust claimant's priority over other creditors. Trusts are important tools for management and disposition of property.[237] Similarly, clients should be able to entrust funds to their lawyers.[238] Neither of these arrangements would be as effective if the beneficiary were at risk of losing her rights through the fiduciary's misappropriation and subsequent bankruptcy. Both depend on the confidence with which the beneficiary can entrust funds or title to property to the fiduciary, with minimal risk in the event of misconduct. The protection the beneficiary receives from a constructive trust remedy is not absolute; it depends on tracing and is lost upon dissipation of the products. But the assurance of a restitutionary remedy that will give the beneficiary a prior right to recover the property or its traceable products (in effect, a right of equitable ownership) may have a real impact on her initial decision to enter the arrangement. Therefore, a constructive trust remedy, applicable in bankruptcy, is necessary to preserve the utility of the fiduciary relationship.

A corollary to the argument of utility is that the claimant should not be entitled to a constructive trust as against other creditors unless there is clear evidence of a fiduciary arrangement for protection of particular property. The term "fiduciary" is sometimes used generally in reference to a wide range of confidential relations,[239] but in this context, its meaning should be limited to established forms of fiduciary arrangements for the management of property. For example, priority is justified in the case of a professional relationship such as attorney and client that requires dependable handling of assets, or when an agreement between the parties imposed traditional trust duties of segregation and accounting in the management of property.[240] It should not extend to more ambiguous

237. *See generally* 1 A. SCOTT & W. FRATCHER, *supra* note 25, § 1.

238. *Cf.* MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102 (1981) (client funds); MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15 (1983) (client funds).

239. Some relations are well established in law as fiduciary relations. Examples are trustee to beneficiary, attorney to client, agent to principal, and director to corporation. Courts also may impose special duties akin to fiduciary duties in a great variety of cases in which one party is dependent on another and vulnerable to unfair advantage. *See* G. BOGERT & G. BOGERT, *supra* note 6, § 482; D. DOBBS, *supra* note 8, § 10.4, at 681; 1 A. SCOTT & W. FRATCHER, *supra* note 25, § 2.5.

240. The fact that courts have applied the fiduciary label to the relationship between the debtor and the constructive trust claimant is not enough to justify priority; it also should appear from the terms of the arrangement that management of particular property is a central purpose. For example, agency is an established form of fiduciary relationship. G. BOGERT & G. BOGERT, *supra* note 6, § 482, at 280; D. DOBBS, *supra* note 8, § 10.4, at 681. But if the terms of the agency do not require

relationships in which the parties did not contemplate full fiduciary responsibility for specific property.

3. *Mistake*

Mistake cases differ from other constructive trust settings in that the defendant did not acquire property by wrongful means.[241] Restitution is granted in cases of mistake because it would be unjust for the defendant to retain benefits to which he has no claim at the claimant's expense.[242]

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the agent to segregate and maintain certain property for the principal, the principal cannot claim to have relied on the relationship as a means of property management, and a constructive trust remedy against the agent's creditors is not necessary to protect the utility of the relationship. In such a case, the principal effectively extended credit to the agent. *See In re* Morales Travel Agency, 667 F.2d 1069, 1071-72 (1st Cir. 1981) (refusing to impose a constructive trust on proceeds of ticket sales when the ticket agency agreement did not provide for segregation of funds); *see also* McKee v. Paradise, 299 U.S. 119, 121-23 (1936) (distinguishing between an express trust relationship and a debtor-creditor relationship on grounds of intent and segregation of res); Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962, 971-72 (5th Cir. 1983) (denying a subcontractor's constructive trust claim based on joint check agreement between the contractor and project owners, because the agreement did not impose specific duties of segregation or disbursement on contractor); 1 A. SCOTT & W. FRATCHER, *supra* note 25, §§ 12.1-12.2 (distinguishing between trust and debt). In the case of a corporate fiduciary who misappropriates assets from the corporation, a constructive trust remedy seems appropriate on grounds of utility. The corporation has chosen its officers and directors, but the assurance of specific restitution of assets wrongfully diverted from the corporation is important to the functioning of the entity. For an example of a constructive trust claim in bankruptcy based on misappropriation by a corporate director, see City Nat'l Bank v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988).

241. There are many forms of mistake. Each has different remedial consequences, and only a few are mentioned here. *See generally* D. DOBBS, *supra* note 8, § 11.1; E. RE, *supra* note 61, at 486-87. A complete catalogue can be found in 2 G. PALMER, *supra* note 2, §§ 10.9, 11.1-12.22, 3 *id.* §§ 13.1-17.7. Constructive trusts (or specific restitution) may be used to restore property the claimant transferred to the defendant without obligation to do so or, in connection with rescission of a contract, to restore property transferred in performance of the avoidable contract. A constructive trust also may be imposed in cases of mistake in integration, if reformation of the document will not afford complete relief. *See* 2 G. PALMER, *supra* note 2, § 11.5(c), (d) (general discussion), § 12.6(b) (mistake in assumption); 3 *id.* § 13.7 (mistake in integration), § 14.3, at 156-57 (mistake in performance).

The statement in the text that the defendant is an innocent recipient of benefit is not accurate in all cases. Mistake in negotiated transactions often shades into misrepresentation or nondisclosure. For example, when one party is mistaken about a term or fact underlying the transaction, the other may notice the error but say nothing. *Cf.* Elin v. Busche (*In re* Elin), 20 Bankr. 1012 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983) (husband's deed conveyed a lesser interest than agreed, apparently by mistake); Panco v. Rogers, 19 N.J. Super. 12, 87 A.2d 770 (Ch. 1952) (evidence did not establish that the buyer was aware of the seller's mistake as to the price stated in contract); *see* RESTATEMENT (SECOND) OF CONTRACTS § 161(b), (c), (d) (1981); *see also* Traveler's Ins. Co. v. Angus (*In re* Angus), 9 Bankr. 769 (Bankr. D. Ore. 1981) (insurance company claimant compensated the debtor for the loss of a ring based on the debtor's apparently mistaken claim).

242. When the claimant mistakenly confers an unsolicited benefit on the defendant, such as a payment of money, or confers more value than is due in performance of a contract with the defendant, the basis for restitution is the defendant's receipt of a benefit the claimant did not intend to confer and to which the defendant had no claim. *See* D. DOBBS, *supra* note 8, § 11.7, at 755-56; 3 G. PALMER, *supra* note 2, § 14.1(a), (b). When parties enter an agreement on the basis of a mutual mistake in assumption, the best explanation for rescission and restitution is that the mistake produces an unequal exchange of values which is different from what either party expected. *See* 2 G. PALMER, *supra* note 2, § 12.2; *cf.* Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978) (an economic view focusing on incentives for production of information). Courts traditionally have refused relief for "unilateral" mistakes in contract negotiation. For analyses of the problem of unilateral mistake, see D. DOBBS, *supra* note 8, § 11.4; 2 G. PALMER,

At first glance, the absense of wrongdoing may appear to weaken the plaintiff's case for priority over other creditors in bankruptcy. But just as deterrent reasons for a constructive trust against a wrongdoer have no bearing when the remedy applies against the wrongdoer's creditors, so the innocence of the recipient should not affect the question of priority in bankruptcy.

One example of a mistake claim in bankruptcy is *Lane Bryant, Inc. v. Vichele Tops, Inc. (In re Vichele Tops, Inc.)*.[243] The claimant made out a check to "Vichele Financial Ltd./Bon Jour Fashion" and mistakenly sent it to the debtor, which deposited the check in its bank account. In a subsequent bankruptcy proceeding, the court denied the claimant a constructive trust, stating that the claimant should not "profit from its own negligence at the expense of those who have dealt with the debtor in a more diligent fashion."[244]

The court in *Vichele Tops* was correct in comparing the claimant's position to that of other creditors, but it misconceived the important points of comparison. As between a constructive trust claimant and other creditors, the primary reason for the constructive trust claimant's priority is the equation of the debtor's gain with the claimant's loss. This element is present in a case of mistake to the same extent as in a case of misappropriation. A constructive trust remedy in bankruptcy does not allow the claimant a "profit," as the court suggested in *Vichele Tops*. The effect is simply to withhold from other creditors a gain to which the debtor had no right, and which he obtained at the claimant's expense.

It is true that Lane Bryant was careless in mailing a check to the wrong party. Outside bankruptcy, the claimant's negligence generally does not affect her right to relief, because it does not alter the conclusion that the defendant received an undeserved gain.[245] In a bankruptcy setting, the claimant's lack of care could be relevant to the question of priority, but only if it were serious enough to place in question the claimant's status as an involuntary creditor. At some point, extreme lack of care in disposing of property may be comparable to a voluntarily extension of credit and an assumption of the risk of the transferee's insolvency. But most mistakes involve some failure of diligence, and to allow creditors to

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supra note 2, §§ 12.3, 12.4; Kronman, *supra*, at 1-9, 32-34. No attempt is made here to reconsider the bases for restitution between parties outside bankruptcy.

243. 62 Bankr. 788 (Bankr. E.D.N.Y. 1986).

244. *Id.* at 792.

245. *See* RESTATEMENT (SECOND) OF CONTRACTS § 157 (1981); RESTATEMENT OF RESTITUTION § 59 (1937); D. DOBBS, *supra* note 8, § 11.7, at 755-56; 3 G. PALMER, *supra* note 2, § 16.3. When the claimant seeks rescission and restitution on the basis of a mistake in basic assumptions in contract negotiations, negligence may have some bearing on the right to restitution, though the more important issue is conscious assumption of the risk of error. *See* D. DOBBS, *supra* note 8, § 11.2, at 720-21; 2 G. PALMER, *supra* note 2, § 12.3, at 561-62, § 12.5 (allocation or assumption of risk); 3 *id.* § 16.3, at 464-66 (negligence); Rabin, *A Proposed Black-Letter Rule Concerning Mistaken Assumptions in Bargain Transactions*, 45 TEX. L. REV. 1273, 1292-99 (1967).

share in property mistakenly contributed by a claimant who did not intend to deal with the debtor places a harsh penalty on carelessness.

Mistakes also occur in negotiated transactions between the claimant and the debtor. In such a case, the commercial character of the transaction and the nature of the mistake will affect the comparison between the constructive trust claimant and other creditors. One illustration is *Elin v. Busche (In re Elin)*, a case of mistake in integration.[246] Several years before the debtor's bankruptcy, the debtor agreed to convey his interest in a house to the claimant, who was then his wife. Due to a lawyer's error, the deed conveyed only minor rights, and the debtor retained a half interest in the property. The district court imposed a constructive trust in favor of the wife (in aid of reformation), and this seems to be the right result. The wife might have read the deed more carefully or sought legal advice, but she was not entering a commercial transaction with the debtor, in which the risk of a drafting error was comparable to the credit risks assumed by a contract creditor. In the circumstances, the court should not penalize her for lack of diligence.

On the other hand, suppose the debtor and the claimant, a dealer in cattle, agreed to the sale of a pedigreed cow at a low price. Both parties believed the cow was barren. After the claimant delivered the cow, it became evident that the cow was not barren and was worth ten times the price the buyer paid. Outside bankruptcy, assuming a definite mistake by both parties, the seller probably could rescind the sale and obtain restitution of the cow on the ground of a mutual mistake in the basic assumptions underlying the contract.[247]

In the buyer's bankruptcy, though, the seller of the cow does not have a strong case for priority over general creditors. Unlike the claimant in *In re Elin*, the seller entered into a commercial exchange with the debtor, and a mistaken assumption of facts about the cow may be a hazard of the trade. This is not a problem of "conscious uncertainty"[248] or of negligence. It is assumed for present purposes that the seller held a

246. 20 Bankr. 1012 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983).

247. These facts are taken, with alterations, from Sherwood v. Walker, 66 Mich. 568, 568-72, 33 N.W. 919, 919-21 (1887). In that case, the seller discovered the mistake before delivering the cow and refused to perform the contract. The buyer then brought an action of replevin. The court held for the seller on the ground of a mutual mistake about the "nature" of the subject matter of the agreement. *Id.* at 576-78, 33 N.W. at 923-24. A dissenting judge took a different view of the facts and argued there was at best a mistake by the seller, in which case the court should not deny the buyer the deal he made and expected. *Id.* at 578-85, 33 N.W. at 924-27 (Sherwood, J., dissenting). The case is discussed in D. DOBBS, *supra* note 8, § 11.3, at 725; 2 G. PALMER, *supra* note 2, § 12.1, at 532-33, § 12.3, at 562. On mistake in assumptions, see generally D. DOBBS, *supra* note 8, §§ 11.3-11.4; 2 G. PALMER, *supra* note 2, §§ 12.1-12.5; Rabin, *supra* note 245.

248. If the claimant understood when entering the transaction that the fertility of the cow was unknown, there is no mistake and no substantive basis for restitution, even between the original parties. RESTATEMENT (SECOND) OF CONTRACTS § 154(b) & comment c (1981); *see* D. DOBBS, *supra* note 8, § 11.2, at 718-21; 2 G. PALMER, *supra* note 2, § 11.4(c), at 512-14, § 12.5(b), (c); Rabin, *supra* note 245, at 1291-94. Both Professors Dobbs and Palmer distinguish conscious lack of knowledge or belief from lesser degrees of doubt or uncertainty, which do not preclude relief for mistake between the original parties.

genuine and reasonable, though mistaken, belief of fact. The point is that the risk of such a mistake, in this context, is very close to a voluntary credit risk. The unequal exchange resulting from an honest and reasonable mistake may justify unwinding the transaction when restitution affects only the original parties. But if the mistake was an inherent risk of a commercial transaction, and the restitution claim arises in bankruptcy, the claimant is not fairly distinguishable from other creditors who suffered a loss because they misjudged the debtor's creditworthiness.

F. Reliance by Other Creditors

A final consideration that may enter into the determination of unjust enrichment between a restitution claimant and other creditors in bankruptcy is creditors' reliance on the property at issue. Normally, unsecured creditors do not rely on specific assets in extending credit to the debtor, because they have no assurance that those assets will be available if the debtor defaults.[249] But in some cases, particularly if the constructive trust claim concerns assets that are essential to the operation of the debtor's business, the debtor's apparent ownership of the assets at issue may have influenced general creditors to extend credit.

An example is *Cass v. Jones (In re Jones)*,[250] in which the constructive trust claimant loaned money to the debtor on the debtor's fraudulent representation that he would use the money to purchase a drilling rig. The claimant traced the money into a number of assets, including several businesses the debtor had financed with the fraudulently obtained funds. The debtor's bankruptcy court imposed a constructive trust in the claimant's favor on all the assets of the debtor's businesses, as well as other property into which the claimant traced portions of the funds.[251]

This result ignores a substantial possibility of reliance by other creditors. Although unsecured creditors cannot depend on access to particular property, they are likely to rely on the general appearance that the debtor owns income-producing assets.[252] A very broad constructive trust remedy, as in *In re Jones*, defeats their legitimate expectations.

The problem of creditor reliance in such a case can be addressed through the equitable defenses of laches and estoppel. Briefly, the principle of estoppel prevents the claimant from asserting a claim that conflicts

249. Authorities in support of this view are cited *supra* note 111.

250. 50 Bankr. 911 (Bankr. N.D. Tex. 1985).

251. *Id.* at 913-17, 922-24. The nature of the debtor's businesses is not entirely clear from the opinion; some appear to have engaged in marketing tax shelter limited partnerships.

252. Assuming there were other creditors involved in the bankruptcy proceeding, the court's decision was not at all sensitive to their interests. The court apparently recognized the difference between an equitable lien and a constructive trust, *see id.* at 923, yet it imposed a constructive trust on most assets into which the claimant traced his money, including active businesses. *See supra* notes 20-23 and accompanying text. Further, by the standards developed in this article, this was not a strong case for priority in any of the debtor's assets. The claimant voluntarily loaned money to the debtor in a commercial setting without express fiduciary obligations and under circumstances easily susceptible to fraud. *See supra* notes 223-34 and accompanying text.

with her prior conduct or representations if the defendant has relied on the claimant's conduct and would be unfairly prejudiced by the claim. Laches is a closely related concept that bars relief if the claimant delayed unreasonably in asserting her rights, with resulting detriment to the defendant. Both are traditional defenses to equitable relief.[253]

When a restitution claimant asserts a prior claim to certain assets in bankruptcy by means of a constructive trust, the defenses of laches and estoppel should be available to the trustee on behalf of creditors, because creditors are the parties affected by the remedy. The strongest case for recognizing an equitable defense is one in which the claimant delayed substantially in asserting her rights. In *In re Jones*, for example, a space of more than two years had passed between the fraud and the bankruptcy petition, and the absence of the drilling rig should have been apparent to the constructive trust claimant.[254] Another relevant factor is the claimant's voluntary entrustment of property or funds to the control of the debtor with no indications of a fiduciary relationship, which lays the foundation for estoppel. On the other hand, the essential requirement for laches and estoppel is reliance by creditors. Therefore, even if delay or entrustment is present, equitable defenses should be confined to cases such as *In re Jones* in which the nature of the assets at issue makes it likely that unsecured creditors relied on the debtor's apparent title.

VI. THE PROBLEM OF STATE AND FEDERAL LAW

Defining the respective contributions of state and federal law to the resolution of disputes among creditors is a persistent problem in bankruptcy. Bankruptcy is a method of debt collection: it permits an orderly gathering and division of assets and enables creditors as a group to obtain more value from the debtor's estate than they would realize by individual collection procedures.[255] Federal bankruptcy law does not provide for a general reallocation of rights and interests in bankruptcy proceedings. Instead, bankruptcy courts refer to state law, at least in the first instance,

253. The doctrines of laches and estoppel are summarized in D. DOBBS, *supra* note 8, § 2.3, at 41-44. The concepts are simple, though their application may be complex. Both are distinct from the defense of "change of position," which involves dissipation of the enrichment before the recipient becomes aware of the restitution claim. *See* RESTATEMENT OF RESTITUTION §§ 143, 178 (1937); D. DOBBS, *supra* note 8, § 4.6; 3 G. PALMER, *supra* note 2, § 16.8. For cases suggesting that a constructive trust claimant might be estopped based on entrustment of property to the debtor's use and possession, see *In re* Morales Travel Agency, 667 F.2d 1069, 1073 (1st Cir. 1981); Gray v. Fill (*In re* Fill), 82 Bankr. 200, 225 (Bankr. S.D.N.Y. 1987).

254. Cass v. Jones (*In re* Jones), 50 Bankr. 911, 913, 916 (Bankr. N.D. Tex. 1985) (fraud in January 1981; bankruptcy filing in September 1983).

255. T. JACKSON, *supra* note 75, at 10-19; Warren, *supra* note 75, at 787. The primary benefit to creditors comes from efficiencies in the use of the debtor's assets. Reorganization or orderly liquidation in a collective proceeding can preserve going concern values that would be lost if the estate were dismantled by individual collection measures. T. JACKSON, *supra* note 75, 14-15. In addition, Professor Jackson explains that the collective proceeding provides a degree of certainty that may be valuable to risk averse creditors, and avoids excessive monitoring by creditors. *Id.* at 15-16. If these savings exceed the costs of the collective proceeding, bankruptcy reduces the costs of credit. *Id.* at 14. *See also* Baird & Jackson, *supra* note 75, at 104-09.

to determine interests in property and fix the distributional rights of claimants.[256] Federal law displaces the preexisting state law rights of creditors only to the extent required by federal policies specially related to the bankruptcy process.[257]

There is substantial debate, however, about the proper scope of federal bankruptcy policy. On one side, Professors Baird and Jackson contend that maximization of asset values is the sole concern of bankruptcy law and the limit of bankruptcy policy. In their view, "distributional" questions, relating to the allocation of value among claimants, are not bankruptcy questions. Therefore bankruptcy courts should not disturb state law entitlements, except as necessary for efficient management of assets in the collective bankruptcy proceeding.[258]

Professor Warren, on the other hand, describes bankruptcy law as a response to the special problems of a general default. A debtor's general financial collapse raises questions of fair distribution and public interest that are not present in disputes between the debtor and individual creditors. Thus in Professor Warren's view, bankruptcy policy is not confined to maximization of assets: it also must address the distributional issues produced by a large-scale default.[259]

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256. This is discussed *supra* note 75 and accompanying text.

257. *See* Hill, *supra* note 75, at 1035-50 (applying the *Erie* doctrine as a limit on equitable subordination in bankruptcy).

258. T. JACKSON, *supra* note 75, at 22-27; Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987); Baird & Jackson, *supra* note 75, at 101-09. These authors argue that bankruptcy is concerned with the use of assets, which is distinct from allocation of ownership rights in assets. Distributional issues are issues of general law, which should be solved by generally applicable rules, rather than rules unique to bankruptcy. T. JACKSON, *supra* note 75, at 24-27, 31-32; Baird, *supra*, at 819-20; Baird & Jackson, *supra* note 75, at 101-04. Further, whenever bankruptcy law reallocates creditors' rights for reasons unrelated to the greater efficiency of the collective process, it induces strategic behavior that can impair efficiency. T. JACKSON, *supra* note 75, at 24-27; Baird, *supra*, at 824-28; Baird & Jackson, *supra* note 75, at 104. *But see* Carlson, *Philosophy in Bankruptcy* (Book Review), 85 MICH. L. REV. 1341, 1377-88 (1987) (questioning the efficiency of a bankruptcy system that is indifferent to distributional issues and neutral in its treatment of nonbankruptcy entitlements).

Professor Jackson's analysis of constructive trusts in bankruptcy focuses on the distinction between state-created priorities that are intended to operate only in bankruptcy and those that are applicable outside bankruptcy. He argues that while the former conflict with the function of bankruptcy law, the latter should be given effect in bankruptcy proceedings. Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy: Undoing the Confusion*, 61 AM. BANKR. L.J. 287 (1987). Professor Jackson's article is concerned primarily with statutory "constructive trusts," though his analysis appears to extend to constructive trusts imposed by courts as a remedy against unjust enrichment. He suggests that constructive trusts are indistinguishable in substance from statutory liens, which are limited by express provisions of the Bankruptcy Code. *See id.* at 291-99; 11 U.S.C. § 545 (1982 & Supp. IV 1986).

259. Warren, *supra* note 75. Professor Warren explains that nonbankruptcy collection rules are intended for general application to all disputes between debtors and creditors. When state rules do not provide a satisfactory resolution to the issues raised by a multiple default, it is appropriate for bankruptcy law and bankruptcy judges to make distributional judgments. *Id.* at 778-89. A variety of principles and policies influence distributional choices in bankruptcy, including but not limited to efficient use of assets. *Id.* at 789-95, 812-13; *see also* Carlson, *supra* note 258, at 1377-88; Eisenberg, *supra* note 75, at 955-56.

The debate on the scope of bankruptcy policy may reflect different assumptions about the basic object of creditors' rights law. Professor Jackson indicates that his objective is to reduce the costs of

The constructive trust problem illustrates the weakness of the narrow view of bankruptcy policy proposed by Professors Baird and Jackson: it denies bankruptcy courts the power to tailor remedial decisions to the cases before them. The decision to impose a constructive trust in bankruptcy is a distributional decision, because it affects the relative values of the parties' nonbankruptcy rights.[260] But it is also a remedial decision that should not be separated from the facts and parties before the court. A constructive trust will not serve its purpose as a remedy for unjust enrichment unless the question of unjust enrichment is decided by the bankruptcy court, with reference to the parties actually affected.

In theory, the proposals set out in this article for applying constructive trusts among creditors could be treated as suggestions for state courts, which would enter into bankruptcy only as part of a nonbankruptcy entitlement. In practice, though, the entitlement approach will not work, because state courts rarely decide the questions at stake. Unjust enrichment of general creditors at the expense of a constructive trust claimant in a competition for scarce assets is a problem unique to collective creditor proceedings. The wide use of bankruptcy makes it rare that state courts will decide such a case.[261]

Thus if bankruptcy courts treat constructive trust claims as questions of state law entitlement, as Professors Baird and Jackson suggest, their decisions will be based on state law precedents set in disputes between the claimant and the wrongdoer. Importing those precedents into bankruptcy defeats the purpose of the constructive trust remedy by distorting the determination of unjust enrichment. In bankruptcy, the relevant question is unjust enrichment of creditors. The constructive trust remedy will be more consistent with the substantive nonbankruptcy principle it enforces—the principle of unjust enrichment—if the bankruptcy

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credit. *See* T. JACKSON, *supra* note 75, at 14. Professor Warren is concerned with a fair allocation of losses among all persons affected by a default. *See* Warren, *supra* note 75, at 777, 787-88; *cf.* Baird, *supra* note 258, at 823-24 (acknowledging broader goals in creditors' rights law, but relegating them to nonbankruptcy law, apparently so that bankruptcy law can proceed to reduce costs of credit).

260. Professor Jackson states that the ordering of claims is a "quintessential nonbankruptcy" issue. T. JACKSON, *supra* note 75, at 62.

261. *See* Carlson, *supra* note 258, at 1380-81 (questioning a view of bankruptcy law that assigns all issues of distributional priority to nonbankruptcy law). State courts might address the relative rights of a constructive trust claimant and general creditors in connection with assignments for the benefit of creditors or other collective methods of debt collection governed by state law. However, the determination of claims in state collective procedures is largely consensual and extrajudicial. *See generally* 5 DEBTOR-CREDITOR LAW ch. 24 (T. Eisenberg ed. 1989) (assignments); 8 *id.* ch. 33 (receivership), *id.* ch. 34 (composition and extension); Hanna, *Contemporary Utility of General Assignments*, 35 VA. L. REV. 539 (1949); Shimm, *The Impact of State Law on Bankruptcy*, 1971 DUKE L.J. 879, 881-95; Weintraub, Levin & Sosnoff, *Assignments for the Benefit of Creditors and Competitive Systems for Liquidation of Insolvent Estates*, 39 CORNELL L.Q. 3 (1953). State "insolvency" procedures that intrude on the functions of federal bankruptcy law are preempted by federal bankruptcy legislation. International Shoe v. Pinkus, 278 U.S. 261 (1929); *see* 5 DEBTOR-CREDITOR LAW, *supra*, ¶ 24.02[D]; Hanna, *supra*, at 540-54.

In the absence of state law precedent addressing the rights of creditors, the bankruptcy court might ask what the state court would decide if it considered the problem. In substance, however, the result would be a remedial decision by the bankruptcy court.

court is willing to make a distributional decision between the constructive trust claimant and other creditors.

The principal objection Professors Baird and Jackson raise to distributional decisions in bankruptcy is that they encourage strategic behavior. Special distributional rules in bankruptcy may induce individual creditors to commence a bankruptcy proceeding when bankruptcy is not the most efficient method of collecting and dividing assets.[262] But this assumes that the incremental loss of efficiency in asset management outweighs other concerns.

Suppose creditors decide to file a bankruptcy petition because a bankruptcy court will address constructive trust claims in terms of unjust enrichment of creditors. The petition is strategic in the sense that it is filed for reasons other than collective asset maximization and might produce a bankruptcy that is, to some degree, inefficient. But it promotes the integrity of the constructive trust remedy, because the bankruptcy proceeding brings into focus the interests actually affected by specific restitution. Surely a fair application of the constructive trust remedy in accordance with its purpose of remedying unjust enrichment justifies the possible strategic effects of a policy permitting bankruptcy courts to administer constructive trusts with regard to the interests of general creditors.[263]

VII. CONCLUSION

Properly understood, a constructive trust is a remedy for prevention of unjust enrichment. In the area of creditors' rights, courts often have lost sight of the essential purpose of the remedy. Traditional constructive trust doctrine assumes that if the claimant is entitled to recover unjust gains from the defendant, she also is entitled to priority over the defendant's general creditors. Most bankruptcy courts have accepted this conclusion. Some have been uncomfortable with the results of the constructive trust remedy in bankruptcy, but their response has been to place technical limits on its operation, rather than to reassess the meaning of unjust enrichment in the context of a bankruptcy proceeding.

In bankruptcy, where the burden of a constructive trust falls on general creditors, the court should not impose a constructive trust unless it concludes that without it, general creditors would be unjustly enriched at the claimant's expense. This article has identified three reasons why a restitution claim traceable to specific assets of a debtor may have special appeal in relation to the claims of other creditors. These are the corre-

262. T. JACKSON, *supra* note 75, at 24-27; Baird, *supra* note 258, at 824-28; Baird & Jackson, *supra* note 75, at 104.

263. Alternatively, bankruptcy courts might refuse to entertain constructive trust claims on the ground that in a bankruptcy proceeding, the claim of unjust enrichment is not strong enough to justify the costs of decision. Once again, the decision should be a bankruptcy decision. A determination that the remedy lacks utility in bankruptcy is more important than the strategic effects of a federal rule for constructive trusts.

spondence of an unjust gain to the defendant with a loss to the claimant, the presence of the gain among the assets to be divided among creditors, and the position of the claimant as an involuntary creditor. Assuming these reasons (in combination) can justify priority, they also should define the limits of a restitution claimant's priority in bankruptcy. When they are not present and the motives for the constructive trust are primarily deterrent, bankruptcy courts should refuse specific restitution and leave the claimant to share pro rata with other creditors.

In federal bankruptcy proceedings, constructive trusts also raise questions about the relation of state and federal law. The prevailing approach treats the constructive trust remedy as a state law entitlement. The result is to transpose a state law remedy designed to correct unjust enrichment of the individual debtor to a contest between the constructive trust claimant and the debtor's creditors. This is not a principled solution, because it separates the remedy from its purpose. Instead, bankruptcy courts should address constructive trust claims as remedial issues and grant or deny relief according to the relative equities of the claimant and creditors.

Perhaps a remedial application of constructive trusts in bankruptcy is not feasible, because the litigation required is too costly to justify its results. If so, the answer must be to exclude all constructive trust claims from bankruptcy, rather than to avoid difficult decisions by referring to equitable ownership and state law entitlement.